POTLATCH 2002 ANNUAL REPORT

ON THE COVER:

An important commercial species that Potlatch manufactures into premium decking and siding, Western Red Cedar is also permanently protected in Potlatch's privately maintained Walker Park in North Central Idaho.

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FINANCIAL HIGHLIGHTS

(Dollars in thousands – except per-share amounts)	2002	2001	2000
Net sales	$1,286,217	$1,274,585	$1,293,193
Loss from continuing operations	(50,933)	(56,566)	(33,393)
Net loss	(234,381)	(79,445)	(33,214)
Net cash provided by (used for) operations	(69,144)	34,474	72,384
Per common share:			
Basic net loss	$ (8.23)	$ (2.81)	$ (1.16)
Diluted net loss	(8.23)	(2.81)	(1.16)
Cash dividends paid	.60	1.17	1.74
Stockholders' equity	15.07	24.98	28.69
Working capital	$ 102,693	$ 612,384	$ 745,052
Depreciation, amortization and cost of fee timber harvested	115,469	115,033	108,722
Capital expenditures	51,614	42,679	142,812
Total assets	1,616,326	2,487,146	2,542,445
Long-term debt (noncurrent portion)	622,645	820,522	801,549
Stockholders' equity	430,791	707,304	813,236
Average common shares outstanding (in thousands)	28,462	28,282	28,523

Certain amounts for 2000 and 2001 have been conformed to the 2002 presentation.

Potlatch Corporation, founded in 1903 in Potlatch, Idaho, is a diversified forest products company with 1.5 million acres of timberlands in Arkansas, Idaho and Minnesota. Our manufacturing facilities convert wood fiber into two main product lines: bleached fiber products (bleached kraft pulp, paperboard and consumer tissue) and wood products (oriented strand board, lumber, plywood and particleboard). Potlatch's business philosophy is committed to increased earnings and a superior rate of return, achieved by talented, well-trained and highly motivated people who are properly supported by a sound financial structure and a keen sense of responsibility for the environment and to all of the publics with whom the company has contact.

Potlatch, along with much of the forest products industry, endured another difficult and challenging year in 2002. While Potlatch's overall financial performance during the year was disappointing, our Board of Directors and management team continued to advance the company-wide strategy of refocusing our resources on those businesses with the greatest potential for growing earnings and adding shareholder value over time. This past year we pursued that strategy by making significant changes in the company's structure through the sale of assets and the exit from some product lines and businesses. We also built on the strategy through investments in new proprietary products and expansion of existing businesses.

Asset sales and related activities, coupled with a salaried workforce restructuring in the fourth quarter, resulted in significant non-recurring charges during the year – most of them non-cash – which in combination with challenging market conditions for our business segments contributed to a substantial loss for the year. Despite the reported loss, the company maintained a positive cash flow that allowed us to continue strengthening our balance sheet through retirement of debt as well as investing in potential high-return projects.

In summary, all business segment performance was influenced by general economic sluggishness and the unusual strength of the U.S. dollar, which peaked against foreign currencies early in 2002 and then began a modest decline in the first half that continued through the year and into 2003. Although the dollar presently remains overvalued on an historic basis, the declines over the past 12 months are beginning to exert positive influences on many of our markets.

Our Resource Division experienced stronger earnings in 2002 due to improved external sales volumes and realizations as well as the sale of surplus property in Oregon, Minnesota and Arkansas.

Oversupplied international markets for most lumber and panel products challenged our Wood Products Division throughout the year despite a robust domestic housing industry. This pattern first emerged in mid-2000 and has prevailed each year since, negatively influencing prices for all wood products. Lumber prices fell to historic lows as imports accelerated in spite of U.S.-imposed duties for Canadian softwood lumber. At this writing, we are hopeful that a long-term negotiated solution will finally resolve our long-standing concern over Canada's subsidized resource allocation practices. In the interim, however, the Canadians continue to push wood products across our border and thus contribute to lower pricing for all North American producers.

A 23-day strike at the company's Southern Unit in Warren, Arkansas, contributed to the wood product segment's losses, but ultimately concluded with agreement on a competitive contract. The Bradley hardwood lumber mill in Warren was permanently closed in the third quarter and Potlatch exited the hardwood lumber business. Although recent capital improvements had enhanced this mill's productivity, ongoing raw material limitations prevented attainment of optimum efficiency. We subsequently sold the Bradley property to an independent Arkansas entrepreneur.

Our pulp-based businesses experienced a net loss for the year, despite the beginning of demand and price improvements for paperboard and a relatively stable tissue market. In January of 2003, unions representing employees at our pulp-based operations in Lewiston, Idaho, approved a new four-year contract. The new contract brings our Idaho pulp and paperboard labor costs more in line with our competitors and was a direct result of positive and constructive attitudes on the part of the union leadership in Lewiston. To assure our customers of adequate product supply during negotiations, we substantially increased inventories of paperboard and tissue, which had a short-term adverse impact on earnings during the year.

In the first quarter of 2003, our printing paper mill in Brainerd, Minnesota, was sold to Missota Paper Company LLC for $4.44 million in cash. Efforts to sell Brainerd had been underway since the mill was permanently closed in mid-May 2002 in conjunction with the sale of most of our printing papers segment's assets in Cloquet, Minnesota, to a domestic subsidiary of Sappi Limited.

"Potlatch has long understood that our financial success is tied to maintaining public trust and acceptance of our resource management practices."

L. Pendleton Siegel (left), Chairman and Chief Executive Officer, and Richard L. Paulson, President and Chief Operating Officer

Proceeds from sale of our printing papers assets were used to retire over $470 million in debt in 2002, which significantly strengthened our balance sheet by reducing interest charges and also freed capital for investment in our resource, wood products and consumer tissue business segments.

Each of our business segments implemented activities during the year that collectively moved us toward realization of our company-wide strategy.

For example, the Resource Division continued to build on its strategy of expanding revenue opportunities by systematically evaluating all lands and resources under its management for their highest and best uses, including recreation leases and conservation easements.

In the second half of 2002, independent third-party forest management audits were conducted on all 1.5 million acres of our forestland in Idaho, Minnesota and Arkansas. Potlatch's management practices were subsequently certified as meeting both the International Organization for Standardization (ISO) Environmental Management System and the Sustainable Forestry Initiative (SFI®) requirements for 2002-2004. As we reported last year, the Forest Stewardship Council (FSC) certified management practices at our Boardman, Oregon, hybrid poplar plantation in 2001 as part of our plan to capitalize on growing markets for certified hardwood lumber.

Potlatch has long understood that our financial success is tied to maintaining public trust and acceptance of our resource management practices. Certification is simply an extension of our commitment to responsible land stewardship. However, the endorsement of these respected organizations provides an extra measure of assurance for our customers, the public and government policy leaders.

While certification facilitates Potlatch's exploration of high-return niche markets for certified wood products, it also lays necessary groundwork for developing non-timber revenue opportunities such as conservation easements. A major step toward the latter objective was made late in the year when Potlatch signed an option agreement with the internationally recognized Trust for Public Land (TPL) to pursue a working forest conservation easement on a substantial portion of our Idaho timberlands. The agreement calls for a phased evaluation of

easement candidate properties, starting in 2003. If approved by our Board of Directors, properties selected during the evaluation process will be permanently protected from commercial and residential development, which are inconsistent with sustainable timber production and recreational and scenic uses. In exchange for foregoing development opportunities, Potlatch will receive compensation – raised from public and private sources – that TPL believes can exceed $40 million.

Our Resource Division has also accepted an invitation from the highly respected Pinchot Institute for Conservation to participate in an independent evaluation of our Idaho forest management practices against SFI and FSC, the two primary North American environmental performance standards. We are the first publicly traded forest products company to participate in such an open comparison of these standards and, as such, we are demonstrating our stewardship commitment and enhancing the credibility of our certification efforts. Results of the comparison, which will be made public, should provide useful information for improving management practices and certification approaches.

In mid-year, our Wood Products Division completed development of new, proprietary panel products that offer great values for both builders and homeowners. Three new oriented strand board (OSB) products include OXTerminator™, a new panel that resists rot and insects and has superior mold inhibiting qualities, and LuminOX®, which has a radiant barrier to reduce heating and cooling costs. Both of these products have patent protection. In addition, we have added OXTreme™, a sub-flooring panel that resists edge swelling due to moisture, to our OSB Sturd-I-Floor line. Each of these new products has met with market acceptance, and we will aggressively expand their market presence in 2003. The division is also exploring other proprietary wood products, which we expect to announce later in the year.

Late last year we began a 30 percent expansion of softwood lumber production at our Arkansas sawmills in Warren and Prescott through the addition of a third shift. That expansion, coupled with productivity improvements throughout the division, should reduce unit costs and increase Potlatch's overall lumber production by roughly 15 percent in 2003.

As previously reported, we believe our private label consumer tissue business will be the company's growth engine through the remainder of this decade as Potlatch continues to meet the expanding needs of our existing customers and broadens our customer base through an aggressive sales effort. Accordingly, the Board of Directors in September approved a $66 million capital project to add a new tissue machine and related converting facilities adjacent to our operations in Las Vegas, Nevada. The new machine employs licensed proprietary through-air-dried (TAD) technology that will enable us to manufacture premium towel products equal to the best quality currently available in the U.S. The new 102-inch-wide machine, scheduled for startup early in 2004, will produce an additional 30,000 tons (3.6 million cases) of premium towel for retail store customers in the West and to service expanding markets in the Midwest and East.

Private label consumer tissue will be Potlatch's growth engine in the current decade as we meet existing customers' growing needs and expand our customer base. A new $66 million tissue machine at Las Vegas, Nevada, will add premium quality towels to the product line by early 2004.

One of Potlatch's new patent-protected wood products, LuminOX® is an oriented strand board panel with a foil-radiant barrier that reduces heating and cooling costs in residential and commercial buildings. Other proprietary wood products are under development.

Quality improvements at our Cypress Bend, Arkansas, paperboard mill permitted Potlatch to capture an increasing share of the high-end packaging market in 2002. The Lewiston, Idaho, operation started achieving new quality and productivity targets late in the year, allowing the mill to begin upgrading its product mix.

In January of 2003 we separated our paperboard and consumer tissue businesses into two separate divisions. This change reflects the increasing requirements of our private label consumer tissue operations in response to our plans for growth.

Our paperboard business enjoyed improved demand for most of its products during the year, with extended order backlogs at both Cypress Bend, Arkansas, and Lewiston. Mid-year price improvements began to take hold gradually during the latter half of 2002, and we expect those improvements to continue into the current year.

Our pulp and paperboard operation in Cypress Bend remains one of the industry's low-cost producers and continues to enhance its reputation for quality as a result of capital improvements completed two years ago. In recognition of the mill's emphasis on quality, Cypress Bend last year earned the Arkansas Governor's Quality Achievement Award. As we noted in last year's annual report, this relentless pursuit of quality has allowed Potlatch to capture an increasing share of the market for high-end packaging, particularly for cosmetics.

Due in large part to the continued dedication and commitment of its workforce, our Lewiston pulp and paperboard operation began achieving quality and productivity targets late in 2002 and into 2003. As we demonstrate consistent quality, we are concentrating on upgrading Lewiston's product mix. We continue to believe our paperboard business has the scale to be competitive, and progress achieved in the past year appears to confirm that belief.

Throughout the year we continued our efforts to reduce costs company-wide and late in 2002 restructured our salaried workforce through job consolidation and phasing out of non-essential activities on an operation-by-operation basis. We expect the restructuring will result in combined annual savings of approximately $7 million.

Potlatch has been fortunate to have outstanding leadership on our Board of Directors through the very challenging decade of the 1990s. We note with sadness the passing of Richard A. Clarke. A Potlatch director for 17 years, Dick was just short of his mandatory retirement. Vivian W. Piasecki reached mandatory retirement age in 2002, after 10 years on our Board. We will all miss their wisdom and guidance.

We are pleased to have obtained the services of two new Board members, both with extensive consumer products experience. Michael T. Riordan, 52, joined Potlatch's Board of Directors effective December 31, 2002. He was most recently Chairman, Chief Executive Officer and President of Paragon Trade Brands, following several years of service as Chairman, Chief Executive Officer and President of Fort Howard Corporation. Lawrence S. Peiros, 47, Group Vice President of The Clorox Company, was elected to the Board, effective

February 1, 2003, and brings over 20 years of strategy and marketing experience in the consumer products industry.

We enter the new year with a mixed economic outlook, which is currently heavily influenced by yet unresolved international issues. However, the weakness in the U.S. dollar over the past nine months is beginning to exert favorable effects on our product lines. While it is impossible to predict just how events will unfold or how they may influence our respective businesses, we can report with certainty that Potlatch is continuing its progress toward a return to sustained profitability. The key to that progress is continued implementation of our strategy of focusing on businesses that have proven potential for growth and in which we have and can maintain competitive advantages. As we have outlined here, each of our business segments has implemented specific actions in the past year that collectively contribute to that strategy. In the months to come, they will continue on that course, which we are convinced will result in stronger earnings and, ultimately, increase shareholder value.

L. Pendleton Siegel
Chairman and Chief Executive Officer

Richard L. Paulson
President and Chief Operating Officer
March 7, 2003

RESOURCE

Operations: Arkansas, Idaho, Minnesota and Oregon
Products: 1.5 million acres of timberland producing a variety of softwood and hardwood species and 17,000 acres of agricultural land growing hybrid poplar.
Sales & Distribution: Arkansas, Idaho and Minnesota.

	2002	2001	2000
Sales ($ in 000's)			
Internal sales	$339,169	$367,737	$315,116
External sales	65,335	38,073	37,208
Total	$404,504	$405,810	$352,324

PULP AND PAPER

Operations: Lewiston, Idaho; Cypress Bend, Arkansas; Las Vegas, Nevada, and Benton Harbor, Michigan
Products: Bathroom and facial tissue, towels and napkins packaged for various store labels; bleached paperboard for packaging liquids and other products and for paper cups and plates; bleached softwood pulp.
Sales & Distribution: Bleached paperboard products and pulp worldwide; tissue products throughout the United States and Canada.

	2002	2001	2000
Sales* ($ in 000's)	$724,213	$751,669	$730,018
Shipments (tons):			
Paperboard	597,968	606,396	574,744
Tissue	164,229	160,748	148,607
Pulp**	42,232	37,787	41,175
Realizations ($ per ton):			
Paperboard	$ 601	$ 642	$ 687
Tissue	1,725	1,782	1,715
Pulp	267	273	466

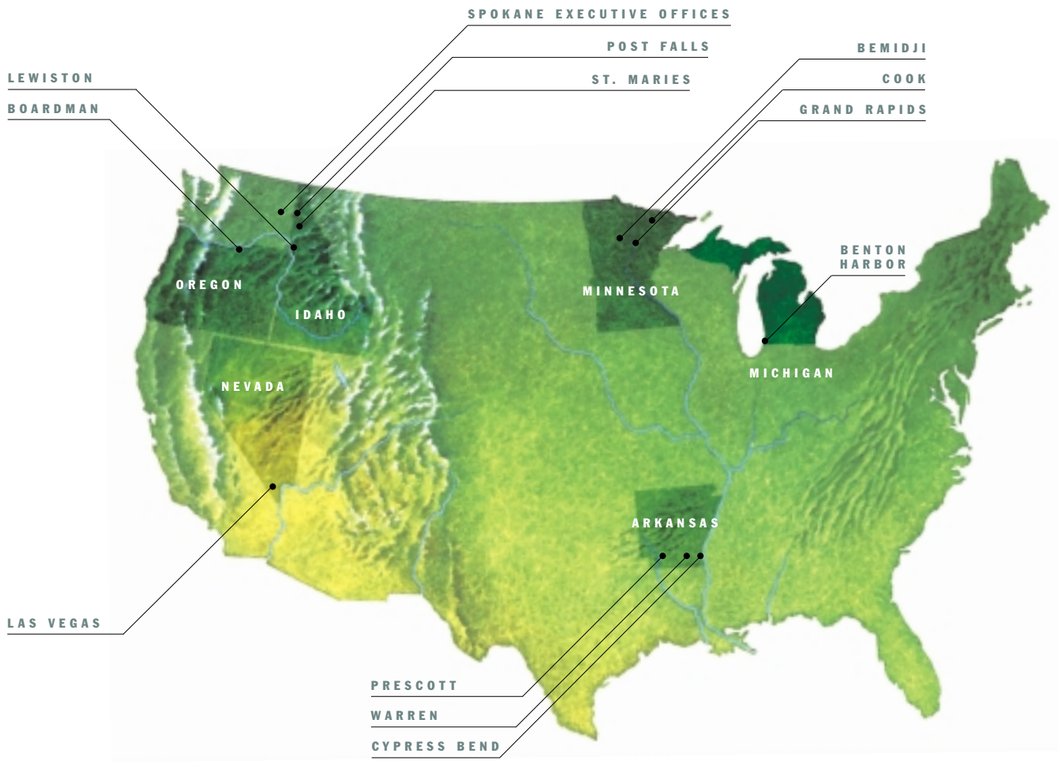
*Excludes internal sales.
**Excludes pulp used internally.

WOOD PRODUCTS

Operations: Arkansas, Idaho and Minnesota
Products: Oriented strand board, lumber, plywood and particleboard.
Sales & Distribution: Throughout the United States.

	2002	2001	2000
Sales* ($ in 000's)	$496,669	$484,843	$525,967
Shipments:			
Oriented strand board (m. sq. ft., 3/8" basis)	1,276,897	1,127,474	1,083,695
Lumber (m. bd. ft.)	679,772	683,828	602,823
Plywood (m. sq. ft., 3/8" basis)	118,820	142,424	171,438
Particleboard (m. sq. ft., 3/4" basis)	61,427	66,049	68,209
Realizations ($ per unit):			
Oriented strand board (m. sq. ft., 3/8" basis)	$129	$129	$172
Lumber (m. bd. ft.)	347	351	372
Plywood (m. sq. ft., 3/8" basis)	268	259	280
Particleboard (m. sq. ft., 3/4" basis)	189	195	239

*Excludes internal sales.



REGIONAL LAND BASES
Arkansas, Idaho, Minnesota, Oregon (a)

SAWMILLS (CAPACITY)
Prescott, Arkansas
200,000 m. bd. ft.
Warren, Arkansas
200,000 m. bd. ft.
Lewiston, Idaho
165,000 m. bd. ft.
St. Maries, Idaho
100,000 m. bd. ft.
Bemidji, Minnesota
90,000 m. bd. ft.

PLYWOOD MILL (CAPACITY) (b)
St. Maries, Idaho
145,000 m. sq. ft.

ORIENTED STRAND BOARD MILLS (CAPACITY) (b)
Bemidji, Minnesota
535,000 m. sq. ft.
Cook, Minnesota
435,000 m. sq. ft.
Grand Rapids, Minnesota
375,000 m. sq. ft.

PARTICLEBOARD MILL (CAPACITY) (c)
Post Falls, Idaho
70,000 m. sq. ft.

BLEACHED KRAFT PULP MILLS (CAPACITY)
Cypress Bend, Arkansas
265,000 tons
Lewiston, Idaho
505,000 tons

BLEACHED PAPERBOARD MILLS (CAPACITY)
Cypress Bend, Arkansas
285,000 tons
Lewiston, Idaho
355,000 tons

TISSUE MILL (CAPACITY)
Lewiston, Idaho
175,000 tons

TISSUE CONVERTING FACILITIES (CAPACITY)
Lewiston, Idaho
120,000 tons
Benton Harbor, Michigan (d)
5,000 tons
Las Vegas, Nevada
45,000 tons

(a) Potlatch owns a 17,000-acre hybrid poplar plantation in Boardman, Oregon.
(b) 3/8" basis
(c) 3/4" basis
(d) Leased facility

2002 CAPACITIES, PRODUCTION AND FIBER FLOW

LAND BASES

ARKANSAS

496,000 acres
Southern yellow pine,
various fine hardwoods

IDAHO

670,000 acres
Western white pine,
white fir, red cedar,
Douglas-fir, larch

MINNESOTA

330,000 acres
Aspen, jack pine,
red pine, balsam fir

SOLID WOOD CONVERTING

PULPWOOD

Own:
587,000 tons
Purchased:
821,000 tons

PULPWOOD SALES
478,000 tons

SAWTIMBER

Own:
722,000 tons
Purchased:
1,040,000 tons

LOG SALES
238,000 tons

2 SAWMILLS

Capacity:
400,000 m. bd. ft.
Production:
354,000 m. bd. ft.

CHIP SALES
294,000 tons

PULPWOOD FIBER

Own:
50,000 cunits (c)
Purchased:
253,000 cunits (c)

FIBER FROM MILLS

Own:
11,000 cunits (c)
Purchased:
23,000 cunits (c)

PURCHASED FIBER
21,000 cunits (c)

PULPWOOD

Own:
170,000 tons
Purchased:
105,000 tons

PULPWOOD SALES
61,000 tons

SAWTIMBER

Own:
1,178,000 tons
Purchased:
287,000 tons

LOG SALES
306,000 tons

2 SAWMILLS

Capacity:
265,000 m. bd. ft.
Production:
246,000 m. bd. ft.

1 PLYWOOD MILL (a)

Capacity:
145,000 m. sq. ft.
Production:
123,000 m. sq. ft.

1 PARTICLEBOARD MILL (b)

Capacity:
70,000 m. sq. ft.
Production:
63,000 m. sq. ft.

PULPWOOD FIBER

Own:
51,000 cunits (c)
Purchased:
32,000 cunits (c)

FIBER FROM MILLS

Own:
84,000 cunits (c)
Purchased:
21,000 cunits (c)

PURCHASED FIBER
526,000 cunits (c)

PULPWOOD (d)

Own:
112,000 tons
Purchased:
881,000 tons

PULPWOOD SALES
246,000 tons

SAWTIMBER/OSB LOGS

Own:
212,000 tons
Purchased:
2,226,000 tons

LOG SALES
5,000 tons

1 SAWMILL

Capacity:
90,000 m. bd. ft.
Production:
88,000 m. bd. ft.

3 ORIENTED STRAND BOARD MILLS (a)

Capacity:
1,345,000 m. sq. ft.
Production:
1,282,000 m. sq. ft.

CHIP SALES
24,000 tons

PULP MANUFACTURING

CYPRESS BEND PULP MILL

Bleached kraft pulp
Capacity:
265,000 tons
Production:
263,000 tons

LEWISTON PULP MILL

Bleached kraft pulp
Capacity:
505,000 tons
Production:
505,000 tons

PULP SALES
42,000 tons

PAPER AND PAPERBOARD MANUFACTURING

OWN PULP

263,000 tons

CYPRESS BEND PAPERBOARD

Bleached paperboard
Capacity:
285,000 tons
Production:
283,000 tons

OWN PULP

348,000 tons

LEWISTON PAPERBOARD

Bleached paperboard
Capacity:
355,000 tons
Production:
346,000 tons

TISSUE CONVERTING

OWN PULP

99,000 tons

OWN WASTE PAPER
19,000 tons

PURCHASED PULP
62,000 tons

LEWISTON TISSUE

Tissue
Capacity:
175,000 tons
Production:
174,000 tons

OWN TISSUE

116,000 tons

PURCHASED TISSUE
14,000 tons

LEWISTON

Capacity:
120,000 tons
Production:
119,000 tons

OWN TISSUE

44,000 tons

PURCHASED TISSUE
2,000 tons

LAS VEGAS

Capacity:
45,000 tons
Production:
42,000 tons

OWN TISSUE

1,000 tons

PURCHASED TISSUE
2,000 tons

BENTON HARBOR

Capacity:
5,000 tons
Production:
3,000 tons

(a) 3/8" basis
(b) 3/4" basis
(c) One cunit equals 100 cubic feet of solid wood.
(d) Harvest amounts include tons used by our Cloquet pulp mill, which was sold in May 2002.

Note: Fiber transfers represent quantities provided without consideration for changes in inventories.

Potlatch Corporation's management has prepared and is responsible for the financial statements, including the estimates and judgments required for their preparation. Management maintains and supports a system of internal controls and internal auditing to provide reasonable assurance that the company's assets are safeguarded and that transactions and events are recorded in accordance with management's authorization and accounting principles generally accepted in the United States. The company's accounting policies and procedures are communicated to all divisions of the organization. In addition, the company's business ethics policy requires employees to maintain a high level of ethical standards in the conduct of the company's business.

The company's financial statements have been audited by KPMG LLP. The independent auditors' report, which is based on an audit made in accordance with generally accepted auditing standards, expresses an opinion as to whether the company's financial statements, considered in their entirety, are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States. In performing its audit, KPMG LLP considers the company's internal control structure to the extent it deems necessary in order to issue its opinion on the financial statements.

The board of directors' audit committee, comprised of three outside directors, meets regularly with management, the internal auditors and the independent auditors to assure that each is meeting its responsibilities regarding the objectivity and integrity of the company's financial statements. The committee reviews the scope and results of the company's internal and external audit activities, nominates the independent auditors to be appointed each year by the board of directors, and reviews with management and the independent auditors current and emerging accounting and financial requirements and practices affecting the company.

L. PENDLETON SIEGEL

Chairman of the Board and Chief Executive Officer

GERALD L. ZUEHLKE

Vice President, Finance, Chief Financial Officer and Treasurer

TERRY L. CARTER

Controller

SELECTED FINANCIAL DATA

(Dollars in thousands – except per-share amounts)	2002	2001	2000	1999	1998
Net sales	$1,286,217	$1,274,585	$1,293,193	$1,343,773	$1,243,506
Earnings (loss) from continuing operations	(50,933)	(56,566)	(33,393)	52,210	29,406
Net earnings (loss)	(234,381)	(79,445)	(33,214)	40,947	37,232
Net cash provided by (used for) operations	(69,144)	34,474	72,384	191,422	145,622
Working capital	102,693	612,384	745,052	780,003	687,210
Current ratio	1.4 to 1	2.1 to 1	2.7 to 1	3.1 to 1	3.2 to 1
Long-term debt (including current portion)	$ 638,252	$1,150,125	$ 801,874	$ 712,121	$ 722,134
Stockholders' equity	430,791	707,304	813,236	921,039	930,906
Long-term debt to stockholders' equity ratio	1.5 to 1	1.6 to 1	.99 to 1	.77 to 1	.78 to 1
Capital expenditures	$ 51,614	$ 42,679	$ 142,812	$ 65,277	$ 58,544
Total assets	1,616,326	2,487,146	2,542,445	2,446,500	2,377,306
Basic net earnings (loss) from continuing operations per common share	$(1.79)	$(2.00)	$(1.17)	$1.80	$1.01
Basic net earnings (loss) per common share	(8.23)	(2.81)	(1.16)	1.41	1.28
Average common shares outstanding (in thousands)	28,462	28,282	28,523	28,947	29,000
Diluted net earnings (loss) from continuing operations per common share	$(1.79)	$(2.00)	$(1.17)	$1.80	$1.01
Diluted net earnings (loss) per common share	(8.23)	(2.81)	(1.16)	1.41	1.28
Average common shares outstanding, assuming dilution (in thousands)	28,462	28,282	28,523	28,967	29,020
Cash dividends per common share	$.60	$1.17	$1.74	$1.74	$1.74

Certain amounts for 1998-2001 have been reclassified for discontinued operations and to conform to the 2002 presentation.
See Note 17, Discontinued Operations, on pages 37-38.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

We are a vertically integrated and diversified forest products company. We own approximately 1.5 million acres of timberland and operate 15 manufacturing facilities, located primarily in Arkansas, Idaho and Minnesota. As of December 31, 2002, our business was organized into three segments: (i) Resource, which manages our timberlands and supplies wood fiber to our manufacturing segments and to third parties; (ii) Wood Products, which manufactures oriented strand board (OSB), plywood, lumber and particleboard; and (iii) Pulp and Paper, which manufactures consumer tissue, bleached paperboard and bleached softwood market pulp. As a result of management changes effective in January 2003, the Pulp and Paper segment was split into two separate business segments, the Consumer Products segment and the Pulp and Paperboard segment. In 2003 results for these two segments will be reported separately, with prior year amounts reclassified for comparative purposes.

In May 2002, we exited our Printing Papers segment, which produced primarily high-grade coated printing papers and bleached hardwood market pulp. We sold our Cloquet, Minnesota, pulp and printing papers facilities and certain associated assets to a domestic subsidiary of Sappi Limited for $485.5 million in cash, after closing adjustments. We closed our Brainerd, Minnesota, printing papers mill at the same time.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

In late October 2002 we entered into a memorandum of understanding with a buyer for the sale of the Brainerd facility. The facility was sold on February 28, 2003, for $4.44 million in cash. The sale of the printing papers business reflects a strategic realignment to focus on our natural resources, wood products and consumer tissue businesses, which we believe have the greatest potential for growth.

In June 2002, we announced that we would close our Bradley hardwood mill in Warren, Arkansas, and exit the hardwood lumber business. We sold the facility in August 2002.

For the year 2002, the Printing Papers segment and the Bradley hardwood mill have been accounted for and reported as discontinued operations. Our consolidated financial statements and this discussion reflect the reclassification of these operations as discontinued operations for all periods presented.

CRITICAL ACCOUNTING POLICIES

Our principal accounting policies are discussed on pages 26-28 of this Annual Report. The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported financial position and operating results of the company. Management believes the accounting policies discussed below represent the most complex, difficult and subjective judgments it makes in this regard.

LONG-LIVED ASSETS. We account for long-lived assets in accordance with Financial Accounting Standards Board (FASB) Statement No. 144. The Statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The test for impairment requires management to estimate future cash flows, which can differ materially from actual future results based upon many factors, including but not limited to changes in economic conditions, environmental requirements, and capital spending.

RESTRUCTURING AND OTHER CHARGES. In 2000, 2001 and 2002 we recorded charges for the restructuring of our salaried workforce, the closure of a plywood manufacturing plant and the reduction of the hourly workforce at another site. In May 2002 we also completed the sale of a majority of the assets of our Printing Papers segment and closed a printing papers facility in Brainerd, Minnesota. In July 2002 we closed a hardwood lumber mill in Warren, Arkansas. The mill was sold in August 2002. These events required us to record estimates of liabilities for employee benefits, demolition, environmental clean-up and other costs at the time of the event, and these estimated liabilities could differ materially from actual costs incurred.

ENVIRONMENTAL LIABILITIES. We record accruals for estimated environmental liabilities in accordance with FASB Statement No. 5. These estimates reflect assumptions and judgments as to the probable nature, magnitude and timing of required investigation, remediation and monitoring activities. Due to the numerous uncertainties and variables associated with these assumptions and judgments, and changes in governmental regulations and environmental technologies, our accruals are subject to substantial uncertainties and our actual costs could be materially more or less than the estimated amounts.

PENSION AND POSTRETIREMENT BENEFITS. Substantially all of our employees are covered by noncontributory defined benefit pension plans, and certain salaried and hourly employees are covered by company-sponsored defined benefit retiree health care and life insurance plans. The cost of these plans is accounted for in accordance with FASB Statement Numbers 87, 106 and 132. These Statements require assumptions regarding discount rates and asset returns and, with respect to the post-retirement benefits plans, assumptions regarding medical cost trends. Actual asset returns and medical costs which are more favorable than our assumptions can have the effect of lowering our expense and cash contributions, and conversely, actual results which are less favorable than our assumptions could increase our expense and cash contributions.

FACTORS INFLUENCING OUR RESULTS OF OPERATIONS

Our operating results have been and will continue to be influenced by a variety of factors, including the cyclical nature of the forest products industry, competition, the efficiency and level of capacity utilization of our manufacturing operations, changes in our principal expenses, such as wood fiber and energy costs, changes in the production capacity of our manufacturing operations as a result of major capital spending projects, asset dispositions or acquisitions and other factors.

Our operating results generally reflect the cyclical pattern of the forest products industry. Historical prices for our products have been volatile, and we, like other manufacturers in the forest products industry, have limited direct influence over the timing and extent of price changes for our products. Product pricing is significantly affected by the relationship between supply and demand in the forest products industry. Product supply is influenced primarily by fluctuations in available manufacturing capacity. Demand is affected by the state of the economy in general and a variety of other factors. The demand for our timber resources and wood products is affected by the level of new residential construction activity and, to a lesser extent, home repair and remodeling activity, which are subject to fluctuations due to changes in economic conditions, interest rates, population growth, weather conditions and other factors. The demand for most of our pulp and paper products is primarily affected by the general state of the global economy, and the economies in North America and east Asia in particular.

The markets for our products are highly competitive and companies that have substantially greater financial resources than we do compete with us in each of our markets. Our wood products are subject to competition from manufacturers in North and South America. In addition, our pulp-based products, other than tissue products, are globally traded commodity products. Because our competitors are located throughout the world, variations in exchange rates between the U.S. dollar and other currencies significantly affect our competitive position compared to our international competitors. In addition, our industry is capital intensive, which leads to high fixed costs and generally results in continued production as long as prices are sufficient to cover variable costs. These conditions have contributed to substantial price competition, particularly during periods of reduced demand. Some of our competitors are currently lower-cost producers in some of the businesses in which we operate, and accordingly these competitors may be less adversely affected than we are by price decreases.

Energy has become one of our most volatile operating expenses over the past several years. Substantial price increases commenced in late 2000 and continued in the first half of 2001, before moderating in the second half of 2001. These price increases were substantial and contributed to the net losses we incurred during these periods. Energy prices returned to more normal historical levels in 2002, which had a favorable effect on our results compared to 2001. In periods of high energy prices, market conditions may prevent us from passing higher energy costs on to our customers through price increases and therefore could adversely affect our operating results. We have taken steps through conservation and electrical production to reduce our exposure to the volatile spot market for energy. Our energy costs in future periods will depend principally on our ability to continue to produce internally a substantial portion of our electricity needs and on changes in market prices for natural gas.

Another significant expense is the cost of wood fiber needed to supply our manufacturing facilities. Our timberlands provided approximately 52% of log requirements for our sawmill and plywood manufacturing facilities in 2002 and an average of approximately 63% over the past five calendar years, after adjustment for our exit from the hardwood lumber business. Including logs used for pulp and OSB, the percentages of our fiber requirements supplied by our timberlands were approximately 30% in 2002 and an average of approximately 38% over the past five calendar years, adjusted for our exit from the printing papers and hardwood lumber businesses. The percentage of our wood fiber requirements supplied by our timberlands will fluctuate based on a variety of factors, including changes in our timber harvest levels, changes in our manufacturing capacity and changes in the amount of timber sales to third parties. The cost of various types of wood fiber that we purchase in the market has at times fluctuated greatly because of economic or industry conditions. Selling prices of our products have not always increased in response to wood fiber price increases nor have wood fiber prices always decreased in conjunction with declining product prices. On occasion, our results of operations have been and may in the future be adversely affected if we are unable to pass cost increases through to our customers.

Finally, changes in our manufacturing capacity, primarily as a result of capital spending programs or asset dispositions, have significantly affected our results of operations in recent periods. In September 2000, we closed our plywood mill in Jaype, Idaho, as a result of poor plywood markets, lack of adequate raw materials and long-term transportation concerns. In January 2001, we completed a modernization and expansion of our OSB mill in Cook, Minnesota, which resulted in an increase in annual production capacity from 250.0 million square feet to 435.0 million square feet. In May 2002, we sold a majority of our Printing Papers segment assets to a domestic subsidiary of Sappi Limited and exited the printing papers business. In August 2002, we sold a hardwood sawmill in Arkansas and exited

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

the hardwood lumber business. We are currently in the process of constructing a tissue machine in Las Vegas, Nevada, which we anticipate will increase our tissue-making capacity by 30,000 tons a year when completed in early 2004. Each of these changes has affected or will affect our levels of net sales and expenses, as well as the comparability of our operating results from period to period. Additionally, the profitability of our manufacturing segments depends largely on our ability to operate our manufacturing facilities efficiently and at or near full capacity. Our operating results would be adversely affected if market demand does not justify operating at these levels or if our operations are inefficient or suffer significant interruption for any reason.

RESULTS OF OPERATIONS

At December 31, 2002, our business was organized into three reporting segments: Resource, Wood Products, and Pulp and Paper. Sales or transfers between segments are recorded as intersegment sales based on prevailing market prices. Because of the role of the Resource segment in supplying our manufacturing segments with wood fiber, intersegment sales represent a significant portion of the Resource segment's total net sales. Intersegment sales represent a substantially lower percentage of net sales for our other segments.

In the period-to-period discussion of our results of operations below, when we discuss our consolidated net sales, contributions by each of the segments to our net sales are reported after elimination of intersegment sales. In the "Discussion of Business Segments" sections below, each segment's net sales are set forth before elimination of intersegment sales. Additionally, in discussing our operating results we refer to net sales realizations, which for each product line are calculated by subtracting freight from net sales and then dividing the result by relevant quantities of the product shipped for the period. We believe net sales realizations are helpful in showing trends in the pricing of our products.

YEAR ENDED DECEMBER 31, 2002 COMPARED TO YEAR ENDED DECEMBER 31, 2001

Net sales of $1,286.2 million for the year ended December 31, 2002, were slightly higher compared to net sales of $1,274.6 million recorded for the year ended December 31, 2001. Increases in Resource and Wood Product segment net sales of $27.3 million and $11.8 million, respectively, were partially offset by a decrease in net sales for the Pulp and Paper segment of $27.5 million. Resource sales were greater due to increased sales to external customers, while Wood Products net sales increased as a result of an increase in OSB net sales. The decrease in net sales for Pulp and Paper was primarily due to lower net sales for paperboard.

Expenses for depreciation, amortization and cost of fee timber harvested were $115.5 million for the year ended December 31, 2002, an increase of $.5 million from the prior year amount of $115.0 million.

For the year ended December 31, 2002, materials, labor and other operating expenses increased $18.9 million or 2% to $1,102.1 million from $1,083.1 million in 2001. Repair and maintenance expense and wood fiber costs were higher in 2002, but were partially offset by lower energy costs.

Selling, general and administrative expenses totaled $83.2 million for the year ended December 31, 2002, compared to 2001's expense of $86.3 million. The change was primarily due to bad debt expense incurred in 2001 as a result of a $2.2 million charge related to the insolvency of a pulp broker. In 2002, we expensed the remaining balance due from the pulp broker, totaling $.8 million, after it was determined that collection was not reasonably likely to occur. In addition, bank fees were lower in 2002 versus 2001.

The following three charges were included in the "Restructuring and other charges" line in the Statements of Operations:

- In 2002 we recorded a $9.0 million pre-tax charge for costs associated with the elimination of 106 salaried production and administrative positions. We expect to record an additional $.4 million during the first half of 2003 for costs related to terminated employees whose services have been retained beyond the initial 60-day period following the announced job elimination, as required by Statement of Financial Accounting Standards (SFAS) No. 146. As of December 31, 2002, 82 employees had been terminated, three had assumed other positions within the company as a result of job openings, and 21 were scheduled for termination in the first half of 2003. We expect to pay all material costs related to the reduction by the end of the first half of 2003.
- In March 2001, we recorded a $4.2 million pre-tax charge associated with a workforce reduction plan at our pulp, paperboard and consumer products operations in Idaho. In September 2001, an additional $.4 million pre-tax charge was recorded as a result of final cost determinations for pension and medical benefits. The plan permanently reduced the workforce by 124 hourly production and maintenance positions. As of December 31, 2001, all material costs associated with the plan had been incurred.

- In December 2001, we reversed $1.8 million of an $18.5 million pre-tax charge, taken in September 2000, for costs associated with the closure of our Jaype, Idaho, plywood mill. Our initial estimate of the cost to close the mill included expected costs for some aspects of maintenance and demolition that were not incurred.

Interest expense was $59.9 million for the year ended December 31, 2002, substantially less than the $77.9 million charged against income in 2001. The decrease reflected our net reduction of over $470 million of debt during 2002.

We incurred one-time, pre-tax costs of $15.4 million during 2002 related to our early retirement of over $380 million of outstanding debt. These costs included cash fees and premiums of $10.6 million and the non-cash write-off of related debt financing costs totaling $4.8 million.

For the year ended December 31, 2002, "Other income, net" totaled $15.2 million, compared to expense of $2.2 million in 2001. The 2002 amount was largely due to gains from the sale of nonstrategic timberland and other surplus land sales, interest income and recreational fee income. The 2001 amount included an $11.1 million charge for the cost of equipment removed from service and deferred litigation costs associated with our lawsuit against Beloit Corporation. Interest income of $2.6 million and gains from asset sales of $3.9 million partially offset the charge.

For the year ended December 31, 2002, we recorded an income tax benefit of $32.6 million, reflecting our net loss from continuing operations before taxes, based on an estimated tax rate of 39%. For the year ended December 31, 2001, we recorded an income tax benefit of $36.2 million, also reflecting a tax rate of 39%.

We recorded a net loss from continuing operations of $50.9 million for the year ended December 31, 2002, compared to a net loss from continuing operations of $56.6 million for the year ended December 31, 2001.

We incurred a pre-tax loss on our discontinued operations of $300.7 million in 2002. The discontinued operations included our former Printing Papers segment and a hardwood sawmill. Included in the amount was $276.2 million for loss on the disposition of the properties and $24.5 million in operational losses. In 2001 these operations incurred pre-tax losses of $37.5 million.

Our net loss for 2002 was $234.4 million, compared to $79.4 million in 2001. The unfavorable comparison was due to recognition of the substantial charge for our discontinued operations.

In December, as a result of market declines in our pension assets in the second half of 2002 and a reduction in the discount rate from 7.25% to 6.75%, we recorded in "Other comprehensive loss" an adjustment for a minimum pension liability totaling $33.2 million, after tax. The charge is reflected in the Balance Sheets as an adjustment to Stockholders' equity. We do not expect pension contributions or expense in 2003 to be materially affected by the charge or discount rate change.

DISCUSSION OF BUSINESS SEGMENTS

The Resource segment reported operating income of $62.6 million for the year ended December 31, 2002, up from $55.3 million reported in 2001. Segment net sales were $404.5 million, compared to $405.8 million in 2001. A decrease in internal net sales was largely offset by increased net sales realizations and higher sales volumes to third parties in Idaho, Minnesota and Arkansas. Resource segment expenses decreased 2% to $342.0 million in 2002, compared to $350.5 million in 2001. Decreased purchases of residual fiber reduced costs but were partially offset by increased logging costs.

The Wood Products segment incurred an operating loss of $27.0 million for the year ended December 31, 2002, compared to an operating loss of $26.6 million incurred in 2001. Market conditions were difficult for our wood products due to the industry's oversupply position, which persisted throughout the year, despite a positive new home construction environment. Foreign imports continued to affect pricing during all of 2002, even after imposition of a U.S. duty on Canadian products beginning in May. Net sales for the segment were $509.2 million, slightly higher compared to $502.3 million reported in 2001. Net sales of oriented strand board increased 12% in 2002, to $187.3 million, due to a 13% increase in shipments. A small decrease in lumber shipments, combined with slightly lower net sales realizations, resulted in a net sales decrease to $249.8 million from $251.9 million in 2001. Net sales of plywood decreased 14% to $34.9 million. Plywood shipments were down 17%, due in large part to lower production in 2002 compared to 2001. Production was higher in 2001 due to extra shifts above the normal operating schedule at our St. Maries, Idaho, mill. Net sales of particleboard were $14.1 million, compared to $15.8 million in 2001. Expenses were $536.2 million for the segment in 2002, compared to $528.9 million in 2001. Higher wood fiber costs were partially offset by small declines

in energy and labor costs. Wood fiber costs were higher due in large part to the full year's operation of the Cook, Minnesota, oriented strand board mill. The mill was shut down for a portion of the first quarter of 2001 to complete a modernization and expansion project.

The Pulp and Paper segment reported a slight loss of less than $.1 million in 2002, versus an operating loss of $14.5 million in 2001. Segment net sales decreased to $725.4 million for 2002, compared to $751.7 million in 2001. The decrease was due to lower net sales realizations for paperboard and tissue, combined with a decrease in paperboard shipments. Paperboard net sales declined 6% to $395.1 million from $420.6 million in 2001 due to a 6% decline in net sales realizations. The markets for paperboard reflected the difficult general economic conditions in 2002, as well as increased competition from international producers of paperboard. Consumer tissue product net sales realizations were down 3%, resulting in a decline in 2002 net sales to $315.7 million from $317.7 million in 2001. A $1.2 million increase in pulp net sales, due to a 12% increase in shipments, partially offset the decrease in paperboard and tissue net sales. Segment expenses were $725.4 million in 2002, compared to $766.2 million in 2001. Energy expense was significantly lower in 2002 but was partially offset by higher repair and maintenance expense and wood fiber costs. Repair and maintenance expense was higher due to a scheduled major maintenance shutdown at the Cypress Bend, Arkansas, pulp and paperboard mill and some equipment improvements at the Lewiston, Idaho, pulp and paperboard mill. Included in expenses for 2001 was an $11.1 million charge related to our Beloit Corporation lawsuit and bad debt expense of $2.2 million related to the pulp broker insolvency.

YEAR ENDED DECEMBER 31, 2001 COMPARED TO YEAR ENDED DECEMBER 31, 2000

Net sales of $1,274.6 million for the year ended December 31, 2001, were slightly less than net sales of $1,293.2 million recorded for the year ended December 31, 2000. The decrease was largely due to a decrease in net sales for the Wood Products segment. Net sales for Wood Products fell by $41.1 million, as a result of net sales decreases in OSB, plywood and particleboard. The decrease in net sales for the segment was partially offset by an increase in net sales for the Pulp and Paper segment, which benefited from increased net sales of tissue products. Pulp and Paper segment net sales increased by $21.7 million in 2001. Resource segment net sales were $38.1 million, comparable to 2000's $37.2 million.

Expenses for depreciation, amortization and cost of fee timber harvested were $115.0 million for the year ended December 31, 2001, an increase of $6.3 million from the prior year amount of $108.7 million. The increase was primarily due to increased amortization expense as a result of our debt refinancing activities during the second quarter of 2001 and increased depreciation in the Wood Products segment related to the Cook OSB mill.

For the year ended December 31, 2001, materials, labor and other operating expenses rose by 4% to $1,083.1 million from $1,044.9 million in 2000. An increase in the overall volume of product shipments in 2001 and higher energy costs were largely responsible for the increase. Energy costs were $14.6 million higher in 2001, and included a $1.2 million net charge for fair value adjustments to natural gas derivative hedging contracts used during the year.

Selling, general and administrative expenses totaled $86.3 million for the year ended December 31, 2001, a slight increase from 2000's expense of $85.5 million. The increase was primarily due to increased bad debt expense incurred in 2001 as a result of a $2.2 million charge related to the insolvency of a pulp broker, and was partially offset by cost savings from the reduction in our salaried workforce in June 2000 and a decline in selling expenses related to our consumer tissue products.

The following three charges were included in the "Restructuring and other charges" line in the Statements of Operations:

- In March 2001, we recorded a $4.2 million pre-tax charge associated with a workforce reduction plan at our pulp, paperboard and consumer products operations in Idaho. In September 2001, an additional $.4 million pre-tax charge was recorded as a result of final cost determinations for pension and medical benefits. The plan permanently reduced the workforce by 124 hourly production and maintenance positions. As of December 31, 2001, all material costs associated with the plan had been incurred.
- In 2000, we recorded a $27.9 million pre-tax charge to cover costs associated with a company-wide reduction and reorganization of our salaried production and administrative workforce. In establishing the initial liability, we estimated 261 employees would be terminated. As of December 31, 2001 and 2000, a total of 273 employees had been terminated under the reduction and reorganization plan. As of December 31, 2001, $27.0 million had been recorded against the accrued liability associated with the charge. All remaining costs associated with the workforce reduction program were paid in the first half of 2002.
- In September 2000, we recorded an $18.5 million pre-tax charge for costs associated with the closure of our Jaype, Idaho, plywood mill. As of December 31, 2000, five salaried and 200 hourly production and maintenance employees had been terminated due to the closure. As of December 31, 2001, a total of five salaried and 207 hourly production and maintenance employees had been terminated due to the closure. As of December 31, 2001, $16.5 million had been recorded against the accrued liability associated with the charge, which represented all material costs we expect to incur. Our initial estimate of the cost to close the mill included expected costs for some aspects of maintenance and demolition that were not incurred. As a result, in December 2001 we reversed $1.8 million of the liability and recorded it as income.

Interest expense was $77.9 million for the year ended December 31, 2001, a substantial increase compared to the $59.4 million charged against income in 2000. The increase reflected greater indebtedness in 2001 as well as a higher overall weighted average interest rate on our outstanding debt.

For the year ended December 31, 2001, "Other expense, net" totaled $2.2 million, compared to expense of $3.0 million in 2000. The 2001 amount included an $11.1 million charge for the cost of equipment removed from service and deferred litigation costs associated with our lawsuit against Beloit Corporation, which were determined to be uncollectable due to a reduction in the value of assets available for distribution to unsecured creditors. Interest income of $2.6 million and gains from asset sales of $3.9 million partially offset the charge.

For the year ended December 31, 2001, we recorded an income tax benefit of $36.2 million, reflecting our net loss from continuing operations before taxes, based on an estimated tax rate of 39%. For the year ended December 31, 2000, we recorded a benefit of $21.3 million, also reflecting a tax rate of 39%.

We recorded a net loss from continuing operations of $56.6 million for the year ended December 31, 2001, compared to a net loss from continuing operations of $33.4 million for the year ended December 31, 2000.

We incurred a pre-tax loss on our discontinued operations of $37.5 million in 2001, compared to income of $.3 million in 2000. Discontinued operations included our former Printing Papers segment and a hardwood sawmill.

Our net loss, including discontinued operations, for 2001 was $79.4 million, compared to $33.2 million in 2000.

DISCUSSION OF BUSINESS SEGMENTS

The Resource segment reported operating income of $55.3 million for the year ended December 31, 2001, lower than the $61.4 million reported in 2000. Segment net sales increased to $405.8 million, compared to $352.3 million in 2000. The increase in net sales was due to increased wood fiber sales to our other operating segments in Arkansas, Idaho and Minnesota. Most of the increased volume was procured from outside sources and resold internally. Expenses for the Resource segment were $350.5 million in 2001, greater than the $290.9 million recorded in 2000 due to increased outside wood purchases and higher production costs.

The Wood Products segment's operating loss of $26.6 million for the year ended December 31, 2001, was greater than the operating loss of $17.0 million incurred in 2000, which included an $18.5 million pre-tax charge related to the closure of our Jaype, Idaho, plywood mill. Difficult market conditions prevailed throughout 2001 and worsened in the fourth quarter, necessitating extended shutdowns during the holiday period at most of the segment's mills, adversely affecting earnings. Net sales for the segment were $502.3 million, compared to $538.9 million reported in 2000. A decline in net sales realizations for all of the segment's product lines was largely responsible for the sales decrease. Net sales of oriented strand board decreased 20% in 2001 to $167.2 million, net sales of plywood decreased 21% to $40.5 million, and net sales of particleboard decreased 19% to $15.8 million. An increased volume of shipments offset lower net sales realizations for lumber, as net sales increased to $251.9 million from $232.1 million in 2000. Expenses were $528.9 million for the segment in 2001, compared to $555.9 million in 2000. Wood fiber and energy costs increased in 2001, but overall expenses were lower due to the absence of operating costs related to the Jaype, Idaho, plywood mill, which we closed in September 2000.

The Pulp and Paper segment incurred an operating loss of $14.5 million in 2001, versus operating income of $12.9 million in 2000. Segment net sales increased to $751.7 million for 2001, compared to $730.1 million in 2000. The increase was due to a $35.1 million increase in tissue product net sales. Tissue product shipments were 8% higher, and net sales realizations increased 4% compared to the 2000 period. A $7.5 million decline in pulp net sales, due to an 8% decrease in shipments and a 41% decrease in net sales realizations, partially offset the increase in tissue product net sales. Market-related downtime

at the segment's Lewiston pulp and paperboard mill contributed to the unfavorable results for 2001. Higher energy and wood fiber costs, combined with increases in the volume of paperboard and tissue product shipments, were largely responsible for the $49.0 million increase in segment expenses. Also included in expenses for 2001 were the $11.1 million charge related to our Beloit Corporation lawsuit and bad debt expense of $2.2 million related to the pulp broker insolvency.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2002, our financial position included long-term debt of $638.3 million, including current installments on long-term debt of $15.6 million. Long-term debt (including current installments and early maturing long-term debt) to stockholders' equity was 1.48 to 1 at December 31, 2002, compared to 1.63 to 1 at December 31, 2001. Long-term debt at December 31, 2002 (including current installments and early maturing long-term debt) declined $511.9 million from the December 2001 balance due to normal payments on maturing debt of $132.6 million and the early retirement of $379.3 million of long-term debt, using a portion of the proceeds from the sale of the Printing Papers segment assets. Stockholders' equity declined $276.5 million, largely due to a net loss of $234.4 million for 2002, the recording of a minimum pension liability adjustment of $33.2 million and dividend payments of $17.1 million.

Scheduled payments due on long-term debt during each of the five years subsequent to December 31, 2002 are as follows:

(Dollars in thousands)	
2003	$15,607
2004	607
2005	1,608
2006	2,958
2007	6,759

In September 2002, we placed $15.0 million into an interest-bearing escrow account under the terms of an amendment to our credit agreement. The escrow account's use is restricted to the repayment of $15 million of our medium-term notes, bearing an interest rate of 9.42%, which mature on April 4, 2003.

We had working capital of $102.7 million at December 31, 2002, a decrease of $509.7 million from December 31, 2001. Items decreasing working capital included reductions in assets held for sale of $767.0 million, restricted cash of $83.1 million, short-term investments of $28.5 million and an increase in notes payable of $40.0 million. The decrease in working capital caused by these changes was partially offset by an increase in inventory of $52.1 million and decreases in current installments on long-term debt of $117.0 million, early maturing debt of $197.0 million and liabilities related to assets held for sale of $33.9 million.

Net cash used for operations in 2002 totaled $69.1 million, compared with cash provided by operations of $34.5 million in 2001 and $72.4 million in 2000. An increase in cash used for working capital items in 2002 accounts for a majority of the unfavorable comparison to 2001. The net decrease in cash generated in 2001 compared to 2000 resulted primarily from the following items: a 2001 net loss from continuing operations of $56.6 million versus a 2000 net loss of $33.4 million; a decrease in deferred taxes of $83.4 million in 2001 versus an increase of $18.3 million in 2000; and working capital changes contributing cash of $54.2 million in 2001 compared to using cash of $19.1 million in 2000.

Net cash provided by investing was $65.8 million in 2002, while net cash used for investing was $164.7 million in 2001 and $142.7 million in 2000. Cash was provided in 2002 largely from the use of restricted cash and short-term investments to repay long-term debt. Capital spending of $51.6 million in 2002 was modestly higher than the $42.7 million spent in 2001. In September 2002, we announced plans to spend $66 million to construct a new tissue machine in Las Vegas, Nevada. Spending on this project in 2002 totaled $19.2 million. The balance of capital spending in 2002 focused on routine general replacement, safety, forest resource and environmental projects. The increase in cash used in 2001 compared to 2000 was primarily attributable to the establishment of a restricted cash account totaling $98.2 million at December 31, 2001, and an increase in short-term investments of $30.5 million. These amounts were partially offset by lower capital expenditures, totaling $42.7 million in 2001 compared to $142.8 million in 2000. Capital spending in 2001 focused on routine general replacement, safety, forest resource and environmental projects. Approximately $4.0 million was spent for the completion of the modernization and expansion project at our Cook, Minnesota, OSB mill and another $6.5 million on development of our hybrid poplar plantation in Boardman, Oregon.

Authorized but unexpended capital appropriations totaled $93.3 million at December 31, 2002, all of which is budgeted for expenditure in 2003. As in 2002, spending in 2003 will be concentrated on the new tissue machine in Las Vegas as well as various routine general replacement, safety, forest resource and environmental projects. Spending on projects may be delayed

due to the acquisition of environmental permits, acquisition of equipment, engineering, weather and other factors.

Net cash used for financing totaled $484.0 million in 2002, compared to cash provided by financing of $84.2 million in 2001 and $73.8 million in 2000. The majority of cash used in 2002 was for the retirement of $511.9 million of long-term debt. As discussed above, we used restricted cash to repay our $100 million 6.25% Debentures, and we retired other debt using proceeds from asset sales. Notes payable increased $40.0 million, partially offsetting cash used for debt payments. The increase in cash provided by financing in 2001 compared to 2000 was due primarily to our debt restructuring completed in June 2001 in which we issued $450.0 million of debt, partially offset by debt repayments of $101.7 million and repayment of $188.9 million of notes payable. We also purchased less treasury stock in 2001, spending $10.5 million versus $25.9 million in 2000. In addition, our dividend payments declined substantially in 2001, to $33.1 million from $49.7 million paid in 2000, largely as a result of a dividend rate reduction announced in August 2001.

Cash from discontinued operations in 2002 totaled $488.9 million, most of which was cash received from the sale of our Printing Papers segment assets and the sale of our hardwood sawmill in Arkansas. In connection with the sale of our Printing Papers segment assets in May 2002, we were required under the terms of our bank credit facility to use the proceeds to repay $198.5 million under the term loan portion of our bank credit facility, and all outstanding debt under our revolving credit line at the date of sale, totaling $33.2 million. We also used a portion of the proceeds to retire approximately $164.9 million of additional debt. The discontinued operations generated cash of $42.9 million in 2001 and used cash of $4.2 million in 2000. These amounts were generally the result of the normal operating activities of the discontinued operations during 2001 and 2000.

Our current bank credit facility is comprised of a three-year revolving line of credit of up to $150.0 million that expires June 28, 2004, including a $70.0 million subfacility for letters of credit, usage of which reduces availability under the revolving line of credit. Our obligations under the bank credit facility are secured by our accounts receivable and inventory. As of December 31, 2002, $40.0 million was outstanding under the revolving line of credit and approximately $36.1 million of the revolving line of credit was used to support outstanding letters of credit. In December 2002 we converted $36.1 million of our floating rate municipal bonds to fixed-rate bonds, and retired the remaining $17.8 million of our floating rate municipal bonds. As a result, we cancelled the related letters of credit under the bank credit facility. During the third and fourth quarters of 2002, we negotiated amendments to our bank credit facility, which, among other changes, included reduction of commitments from $200 million to $150 million, approval of the conversion of our floating rate municipal bonds to fixed-rate bonds and revisions to certain financial covenants.

Both the agreement governing our credit facility and the indenture governing our $250 million 10% senior subordinated notes contain certain covenants that, among other things, restrict our ability and our subsidiaries' ability to create liens, merge or consolidate, dispose of assets, incur indebtedness and guarantees, pay dividends, repurchase or redeem capital stock and indebtedness, make certain investments or acquisitions, enter into certain transactions with affiliates, make capital expenditures, or change the nature of our business. The credit facility also contains financial maintenance covenants establishing a maximum funded indebtedness to capitalization ratio, a minimum consolidated net worth requirement, and a minimum interest coverage ratio. Events of default under the credit facility and the indenture include, but are not limited to, payment defaults, covenant defaults, breaches of representations and warranties, cross defaults to certain other material agreements and indebtedness, bankruptcy and other insolvency events, material adverse judgments, actual or asserted invalidity of security interests or loan documentation, and certain change of control events involving our company. We have obtained an amendment to our credit facility modifying the interest coverage ratio calculation, and as a result of this modification, we were in compliance with the covenants of our credit facility as of December 31, 2002.

We believe that our cash, cash flows from operations and available borrowings under our revolving credit facility will be sufficient to fund our operations, capital expenditures and debt service obligations for the next twelve months. When our credit facility expires in June 2004, we will either need to extend the facility or enter into a new credit facility. We cannot assure, however, that our business will generate sufficient cash flow from operations or that we will be in compliance with the financial covenants in our credit facility so that future borrowings thereunder will be available to us. This will be dependent upon our future financial performance, which will be affected by general economic, competitive and other factors, including those discussed under "Factors Influencing Our Results of Operations," many of which are beyond our control.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

At December 31, 2001, Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., Moody's Investors Service Inc. and Fitch, Inc. rated our senior unsecured long-term debt BBB-, Baa3 and BBB-, respectively, all with a negative outlook. In addition, all three organizations listed us on CreditWatch with negative implications. On July 12, 2002, Standard & Poor's announced that it had affirmed its ratings on our debt, including our BBB- corporate rating, and removed us from CreditWatch. On September 23, 2002, it announced that its ratings and outlook would remain unchanged at BBB- with a negative outlook following the announcement that our Board of Directors had approved $66 million to construct a new tissue machine in Las Vegas, Nevada. During the second quarter of 2002 Fitch affirmed our BBB- rating, classified us as stable, and removed us from CreditWatch. Moody's rating of our debt has remained unchanged at Baa3 with a negative outlook. On January 30, 2003, Standard & Poor's announced that it had lowered our senior unsecured debt rating to BB+ and affirmed our senior secured bank loan rating at BBB-. The ratings downgrade by Standard & Poor's caused the interest rate on our $100 million Credit Sensitive Debentures to increase from 9.425% to 12.5%, effective January 30, 2003.

Since December 1999, we have been authorized under a stock repurchase program to repurchase up to two million shares of our common stock. Under the plan, purchases of common stock may be made from time to time through open market and privately negotiated transactions at prices deemed appropriate by management. Through December 31, 2001, a total of 910,900 shares had been acquired under the stock repurchase program. No shares were acquired in 2002, and we do not expect to repurchase additional common stock in the foreseeable future.

It is our practice to periodically review strategic and operational alternatives to improve our operating results and financial position. In this regard, we consider and plan to continue to consider, among other things, adjustments to our capital expenditures and overall spending, the restructuring of our operations to achieve greater efficiencies, and the disposition of assets that may have greater value to others. There can be no assurance that we will be successful in implementing any new strategic or operational initiatives or, if implemented, that they will have the effect of improving our operating results and financial position.

ENVIRONMENT

We are subject to extensive federal and state environmental regulations at our operating facilities and timberlands, particularly with respect to air emissions, wastewater discharges, solid and hazardous waste management, site remediation, forestry operations and endangered species. We endeavor to comply with all environmental regulations and regularly monitor our activities for such compliance. Compliance with environmental regulations is a significant factor in our business and requires capital expenditures as well as additional operating costs. Capital expenditures specifically designated for environmental compliance totaled approximately $1 million during 2002 and are budgeted to be approximately $1 million in 2003.

In early 1998 the Environmental Protection Agency (EPA) published the "Cluster Rule" regulations specifically applicable to the pulp and paper industry. These extensive regulations govern both air and water emissions. During 2001, we completed modifications to process equipment and operating procedures to comply with Phase I of the regulations. Phase II of the regulations relates to control of high volume, low concentration emissions at kraft pulp mills, and our compliance efforts are scheduled to be completed in 2006 at an expected cost of approximately $5 million. We do not expect that such compliance costs will have a material adverse effect on our competitive position.

Our pulp mill at Lewiston, Idaho, discharges treated mill effluent into the nearby Snake River. Federal law requires that we comply with provisions of a National Pollution Discharge Elimination System (NPDES) permit. As allowed by federal regulations, we are operating under an NPDES permit which expired in 1997, but which continues to be in force until the effective date of a new NPDES permit. Negotiations for a new permit have been ongoing since its expiration. The EPA published a draft NPDES permit in December 1999, which includes an end-of-the-pipe discharge temperature requirement of 68 degrees Fahrenheit to be achieved within five years of the date a new permit becomes effective. Meeting this requirement would necessitate installation of refrigeration equipment at a total capital cost between $25 million and $30 million. Discussions are ongoing with the EPA and other agencies involved in the reissuance of the NPDES permit. There are regional precedents for a higher temperature limit. Compliance with a higher temperature limit, should it be allowed, could be achieved with process modifications and less costly equipment configurations than refrigeration. If we are required to install and operate the refrigeration equipment, we believe the pulp mill will be substantially less competitive than similar mills, none of which face such requirements.

The EPA is currently developing its Total Maximum Daily Load (TMDL) regulations for temperature. This process is not expected to be completed until late 2003, and may clarify the requirements to be placed on the Lewiston mill discharge. The currently proposed temperature TMDL, in conjunction with recently promulgated Idaho Water Quality Standards, would require considerably less significant temperature reduction to our discharge, consistent with other pulp mill discharges in the region. If approved as drafted, the new TMDL and water quality standards would likely result in a modification to our draft NPDES permit, allowing for a mixing zone for temperature, rather than an end-of-the-pipe temperature limit.

The EPA is currently developing environmental regulations, collectively known as Maximum Achievable Control Technology (MACT) rules, which could affect our wood products operations as well as our power boiler generating facilities. The MACT rules for power boiler facilities were proposed in November 2002, and those for wood products operations are not expected to be proposed until early 2003. Compliance is not expected to be required before 2006. We are currently studying the proposed MACT rules for power boiler operations, and after the proposed rules for wood products operations are published, we will be able to reasonably estimate the capital expenditures necessary for compliance, although we do not expect such compliance costs to have a material adverse effect on our competitive position.

We believe that our facilities are currently in substantial compliance with applicable environmental laws and regulations. We cannot assure, however, that situations which will give rise to material environmental liabilities will not be discovered or that the enactment of new environmental laws or regulations or changes in existing laws or regulations will not require significant expenditures by us.

INCOME TAXES

Our effective tax rate for 2002, 2001 and 2000 was 39.0 percent.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

Our exposure to market risks on our financial instruments includes interest rate risk on our bank credit facility. In December 2002 all of our other variable rate debt was converted to fixed-rate debt or was retired. As of December 31, 2002, we had $40.0 million of credit facility debt outstanding. The interest rates applied to borrowings under the credit facility are adjusted often and therefore react quickly to any movement in the general trend of market interest rates.

All of our long-term debt is fixed-rate, and therefore changes in market interest rates do not expose us to risk for these financial instruments. However, in December 2001 we entered into a fixed-to-variable interest rate swap to hedge a portion of our 10% senior subordinated debentures. The swap has been designated as a fair value hedge and calls for the company to pay a variable interest amount, based on London Interbank Offered Rate (LIBOR) rates, and receive a fixed-rate payment from a financial institution, calculated on $165.0 million of our 10% senior subordinated debentures. We assume there is no ineffectiveness in the hedge and, accordingly, a fair value increase or decrease in the swap is offset by a corresponding decrease or increase in the value of the underlying debt instrument.

At December 31, 2002, we were not a party to any derivative financial instruments other than the interest rate swap.

COMMON STOCK: MARKETS, PRICES, VOTING RIGHTS AND DIVIDENDS

The company's common stock is traded on the New York, Chicago and Pacific Stock Exchanges. The quarterly and yearly high and low sales price per share of our common stock, as reported in the New York Stock Exchange Composite Transactions in the Wall Street Journal for 2002 and 2001, were as follows:

	2002		2001	
Quarter	High	Low	High	Low
1st	$34.44	$27.85	$34.88	$29.26
2nd	36.13	32.32	36.22	31.03
3rd	33.69	28.35	34.34	26.55
4th	29.88	23.88	29.80	24.90
Year	36.13	23.88	36.22	24.90

In general, all holders of Potlatch common stock who own shares 48 consecutive calendar months or longer ("long-term holders") are entitled to exercise four votes per share of stock so held, while stockholders who are not long-term holders are entitled to one vote per share. All stockholders are entitled to only one vote per share on matters arising under certain provisions of the company's charter. There were approximately 1,900 common stockholders of record at December 31, 2002.

See the discussion under the caption "Liquidity and Capital Resources" in Management's Discussion and Analysis of Financial Condition and Results of Operations on page 19 for information regarding restrictions on our ability to pay dividends. Quarterly dividend payments per common share for 2002 and 2001 were:

Quarter	2002	2001
1st	$.15	$.435
2nd	.15	.435
3rd	.15	.15
4th	.15	.15
	$.60	$1.17

STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

For the years ended December 31 (Dollars in thousands – except per-share amounts)	2002	2001	2000
Net sales	$1,286,217	$1,274,585	$1,293,193
Costs and expenses:			
Depreciation, amortization and cost of fee timber harvested	115,469	115,033	108,722
Materials, labor and other operating expenses	1,102,065	1,083,141	1,044,894
Selling, general and administrative expenses	83,177	86,318	85,469
Restructuring and other charges (Note 15)	8,963	2,750	46,411
	1,309,674	1,287,242	1,285,496
Earnings (loss) from operations	(23,457)	(12,657)	7,697
Interest expense, net of capitalized interest of $300 ($1,032 in 2001 and $3,964 in 2000)	(59,882)	(77,853)	(59,438)
Debt extinguishment costs	(15,360)	–	–
Other income (expense), net (Note 16)	15,202	(2,221)	(3,001)
Loss before taxes on income	(83,497)	(92,731)	(54,742)
Provision (benefit) for taxes on income (Note 7)	(32,564)	(36,165)	(21,349)
Loss from continuing operations	(50,933)	(56,566)	(33,393)
Discontinued operations (Note 17):			
Earnings (loss) from discontinued operations (including loss on disposal of $276,218, $0 and $0)	(300,734)	(37,507)	293
Income tax provision (benefit)	(117,286)	(14,628)	114
Net loss	$ (234,381)	$ (79,445)	$ (33,214)
Other comprehensive loss:			
Minimum pension liability adjustment, net of income tax benefit of $21,231	(33,207)	–	–
Comprehensive loss	$ (267,588)	$ (79,445)	$ (33,214)
Net loss per common share:			
Basic	$(8.23)	$(2.81)	$(1.16)
Diluted	(8.23)	(2.81)	(1.16)

Certain amounts for 2000 and 2001 have been conformed to the 2002 presentation.

The accompanying notes and summary of principal accounting policies are an integral part of these financial statements.

BALANCE SHEETS

At December 31 (Dollars in thousands – except per-share amounts)	2002	2001
ASSETS		
Current assets:		
Cash (Note 11)	$ 8,973	$ 7,475
Restricted cash (Notes 1 and 8)	15,069	98,200
Short-term investments (Note 11)	2,000	30,509
Receivables, net of allowance for doubtful accounts of $1,624 ($1,589 in 2001) (Notes 2 and 8)	117,919	118,632
Inventories (Notes 3 and 8)	159,798	107,713
Prepaid expenses (Note 7)	39,005	31,274
Assets held for sale (Note 17)	5,000	772,033
Total current assets	347,764	1,165,836
Land, other than timberlands	8,750	8,668
Plant and equipment, at cost less accumulated depreciation of $1,260,487 ($1,180,412 in 2001) (Note 4)	758,168	808,763
Timber, timberlands and related logging facilities, net (Note 5)	396,426	395,668
Other assets (Note 6)	105,218	108,211
	$1,616,326	$2,487,146
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Notes payable (Notes 8 and 11)	$ 40,000	$ –
Current installments on long-term debt (Notes 8 and 11)	15,607	132,603
Accounts payable and accrued liabilities (Note 9)	189,452	189,916
Early maturing long-term debt (Note 8)	–	197,000
Liabilities related to assets held for sale (Note 17)	12	33,933
Total current liabilities	245,071	553,452
Long-term debt (Notes 8 and 11)	622,645	820,522
Other long-term obligations (Note 10)	261,165	195,258
Deferred taxes (Note 7)	56,654	210,610
Stockholders' equity:		
Preferred stock, Authorized 4,000,000 shares	–	–
Common stock, $1 par value		
Authorized 40,000,000 shares, issued 32,721,980 shares	32,722	32,722
Additional paid-in capital	131,065	129,978
Retained earnings	409,692	661,144
Accumulated other comprehensive loss:		
Minimum pension liability adjustment	(33,207)	–
Common shares in treasury 4,143,329 (4,410,528 in 2001)	(109,481)	(116,540)
Total stockholders' equity	430,791	707,304
	$1,616,326	$2,487,146

Certain amounts for 2001 have been conformed to the 2002 presentation.

The accompanying notes and summary of principal accounting policies are an integral part of these financial statements.

STATEMENTS OF CASH FLOWS

For the years ended December 31 (Dollars in thousands)	2002	2001	2000
CASH FLOWS FROM CONTINUING OPERATIONS			
Net loss	$(234,381)	$ (79,445)	$ (33,214)
Adjustments to reconcile net loss to net operating cash flows:			
Loss (earnings) from discontinued operations	14,955	22,879	(179)
Loss on disposal of discontinued operations	229,023	–	–
Depreciation, amortization and cost of fee timber harvested	115,469	115,033	108,722
Debt extinguishment costs	15,360	–	–
Deferred taxes	(153,956)	(83,351)	18,317
Other, net	(5,999)	5,114	(2,129)
Decrease in receivables	713	27,499	2,691
Decrease (increase) in inventories	(52,085)	19,077	(17,286)
Decrease (increase) in prepaid expenses	(7,731)	29,879	(37,386)
Increase (decrease) in accounts payable and accrued liabilities	9,488	(22,211)	32,848
Net cash provided by (used for) operations	(69,144)	34,474	72,384
CASH FLOWS FROM INVESTING			
Decrease (increase) in restricted cash	83,131	(98,200)	–
Decrease (increase) in short-term investments	28,500	(30,500)	150
Additions to plant and equipment, and to land other than timberlands	(36,956)	(29,063)	(133,633)
Additions to timber, timberlands and related logging facilities	(14,658)	(13,616)	(9,179)
Disposition of plant and properties	8,097	10,581	3,151
Other, net	(2,333)	(3,893)	(3,149)
Net cash provided by (used for) investing	65,781	(164,691)	(142,660)
CASH FLOWS FROM FINANCING			
Change in book overdrafts	(9,952)	(2,366)	415
Increase (decrease) in notes payable	40,000	(188,943)	67,479
Proceeds from long-term debt	–	450,000	100,000
Retirement of long-term debt	(511,873)	(101,749)	(10,247)
Premiums and fees on debt retirement	(10,584)	–	–
Long-term debt issuance fees	–	(15,553)	–
Issuance of treasury stock	8,146	6,620	952
Purchase of treasury stock	–	(10,453)	(25,892)
Dividends on common stock	(17,071)	(33,108)	(49,698)
Other, net	17,285	(20,293)	(9,256)
Net cash provided by (used for) financing	(484,049)	84,155	73,753
Cash from continuing operations	(487,412)	(46,062)	3,477
Cash from discontinued operations	488,910	42,880	(4,179)
Increase (decrease) in cash	1,498	(3,182)	(702)
Balance at beginning of year	7,475	10,657	11,359
Balance at end of year	$ 8,973	$ 7,475	$ 10,657

Net interest paid (net of amounts capitalized) in 2002, 2001 and 2000 was $65.1 million, $66.1 million and $59.3 million, respectively.

Net income tax payments (refunds) in 2002, 2001 and 2000 were $(16.0) million, $.3 million and $.2 million, respectively.

Certain amounts for 2000 and 2001 have been conformed to the 2002 presentation.

The accompanying notes and summary of principal accounting policies are an integral part of these financial statements.

STATEMENTS OF STOCKHOLDERS' EQUITY

(Dollars in thousands – except per-share amounts)	Common Stock Issued Shares	Common Stock Issued Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock Shares	Treasury Stock Amount	Total Stockholders' Equity
Balance, December 31, 1999	32,721,980	$32,722	$128,678	$ 856,609	$ –	3,749,748	$ (96,970)	$ 921,039
Exercise of stock options and stock awards	–	–	306	–	–	(35,102)	861	1,167
Shares purchased at cost	–	–	–	–	–	660,900	(22,253)	(22,253)
Put options	–	–	–	–	–	–	(4,240)	(4,240)
Premium on issuance of put options	–	–	–	–	–	–	435	435
Net loss	–	–	–	(33,214)	–	–	–	(33,214)
Common dividends, $1.74 per share	–	–	–	(49,698)	–	–	–	(49,698)
Balance, December 31, 2000	32,721,980	$32,722	$128,984	$ 773,697	$ –	4,375,546	$(122,167)	$ 813,236
Exercise of stock options and stock awards	–	–	5	–	–	(750)	19	24
Shares purchased at cost*	–	–	–	–	–	250,000	–	–
Issuance of treasury stock	–	–	989	–	–	(214,268)	5,608	6,597
Net loss	–	–	–	(79,445)	–	–	–	(79,445)
Common dividends, $1.17 per share	–	–	–	(33,108)	–	–	–	(33,108)
Balance, December 31, 2001	32,721,980	$32,722	$129,978	$ 661,144	$ –	4,410,528	$(116,540)	$ 707,304
Exercise of stock options and stock awards	–	–	141	–	–	(25,050)	662	803
Issuance of treasury stock	–	–	946	–	–	(242,149)	6,397	7,343
Net loss	–	–	–	(234,381)	–	–	–	(234,381)
Minimum pension liability adjustment	–	–	–	–	(33,207)	–	–	(33,207)
Common dividends, $.60 per share	–	–	–	(17,071)	–	–	–	(17,071)
Balance, December 31, 2002	32,721,980	$32,722	$131,065	$ 409,692	$ (33,207)	4,143,329	$(109,481)	$ 430,791

*Represents shares purchased pursuant to previously issued put option contracts. The cost of the shares ($10,453) was recorded in treasury stock at the time the put option contract was issued.

The accompanying notes and summary of principal accounting policies are an integral part of these financial statements.

CONSOLIDATION

The financial statements include the accounts of Potlatch Corporation and its subsidiaries after elimination of significant intercompany transactions and accounts. There are no significant unconsolidated subsidiaries.

Potlatch Corporation is an integrated forest products company with substantial timber resources. We are engaged principally in the growing and harvesting of timber and the manufacture and sale of wood products and pulp and paper products. Our timberlands and all of our manufacturing facilities are located within the continental United States. The primary market for our products is the United States, although we sell a significant amount of paperboard to countries in the Pacific Rim.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

EARNINGS (LOSS) PER COMMON SHARE

Earnings (loss) per common share are computed by dividing net earnings by the weighted average number of common shares outstanding in accordance with SFAS No. 128, "Earnings Per Share." The following table reconciles the number of common shares used in the basic and diluted earnings per share calculations:

	2002	2001	2000
Basic average common shares outstanding	28,461,817	28,281,785	28,522,659
Incremental shares due to:			
Common stock options	–	–	–
Put options	–	–	–
Diluted average common shares outstanding	28,461,817	28,281,785	28,522,659

Incremental shares due to common stock options of 17,042 for the year ended December 31, 2002, common stock options of 2,162 and put options of 34,147 for the year ended December 31, 2001, and common stock options of 4,209 and put options of 40,039 for the year ended December 31, 2000, were not included in the diluted average common shares outstanding totals for 2002, 2001 and 2000 due to their antidilutive effect as a result of our net losses for each of those years. Stock options to purchase 1,981,907, 2,508,375 and 2,025,050 shares of common stock for 2002, 2001 and 2000, respectively, were not included in the computation of diluted earnings per share because the exercise prices of the stock options were greater than the average market price of the common shares.

STOCK BASED COMPENSATION

We apply Accounting Principles Board Opinion No. 25 and related Interpretations in accounting for our stock based compensation. No compensation cost has been recognized when options are granted under the plans, as all stock options are granted with an exercise price equal to market value at the grant date. Had compensation costs for the plans been determined based on the fair value at the grant dates for option awards under those plans as prescribed by SFAS No. 123, our net loss and loss per share would have been increased to the pro forma amounts indicated below:

(Dollars in thousands – except per-share amounts)	2002	2001	2000
Net loss, as reported	$(234,381)	$(79,445)	$(33,214)
Stock based employee compensation determined under SFAS No. 123, net of tax	(1,912)	(1,993)	(2,568)
Pro forma net loss	$(236,293)	$(81,438)	$(35,782)
Basic and diluted loss per share, as reported	$(8.23)	$(2.81)	$(1.16)
Pro forma basic and diluted loss per share	(8.30)	(2.88)	(1.25)

INVENTORIES

Inventories are stated at the lower of cost or market. The last-in, first-out method is used to determine cost of logs, lumber, plywood, particleboard and chips. The average cost method is used to determine cost of all other inventories.

PROPERTIES

Property, plant and equipment are valued at cost less accumulated depreciation. Depreciation of buildings, equipment and other depreciable assets is determined using the straight-line method of depreciation. Estimated useful lives range from 30 to 40 years for buildings and structures and 2 to 25 years for equipment.

Timber, timberlands and related logging facilities are valued at cost, net of the cost of fee timber harvested and depreciation or amortization. Cost of fee timber harvested is determined annually based on costs incurred and the related current estimated recoverable volume. Recoverable volume includes growth that has occurred to-date and does not include any anticipated future cost or future growth. Permit timber is timber purchased under contracts where the company does not own the underlying land. The cost of permit timber is capitalized in timber accounts, and these costs are classified as depletion expense as the volume of timber is harvested.

Expenditures for reforestation include all costs related to stand establishment, such as site preparation, costs of seeds or seedlings, and tree planting. All reforestation expenditures representing direct costs incurred for stand establishment are capitalized in reproduction accounts until the timber reaches maturity. Costs are then depleted when harvesting activities begin. Expenditures for forest management, which consist of regularly recurring items necessary to the ownership and administration of our timber and timberlands, are accounted for as current operating expenses.

Logging roads and related facilities on land not owned by us are amortized as the related timber is removed. Logging roads and related facilities on our land are presumed to become a part of our road system unless it is known at the time of construction that the road will be abandoned. Therefore, the base cost of the road, such as the clearing, grading, and ditching, is not amortized and remains a capitalized item until abandonment or other disposition, while other portions of the initial cost, such as bridges, culverts and gravel surfacing, are depreciated over their useful lives, which range from 10 to 20 years. When it is known at the time of construction or purchase that a road will be abandoned after a given event has occurred, the total cost is amortized in the same manner as for roads on non-owned land.

Major improvements and replacements of property are capitalized. Maintenance, repairs, and minor improvements and replacements are expensed. Upon retirement or other disposition of property, applicable cost and accumulated depreciation or amortization are removed from the accounts. Any gains or losses are included in earnings.

LONG-LIVED ASSETS

We account for long-lived assets in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The Statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Assets to be disposed of are reported at the lower of carrying amount or fair value less cost to sell.

INCOME TAXES

The provision for taxes on income is based on earnings or loss reported in the financial statements. Deferred income taxes are recorded under the asset and liability method for the temporary differences between reported earnings and taxable income using current tax laws and rates.

ENVIRONMENT

As part of our corporate policy, we have an ongoing process to monitor, report on and comply with environmental requirements. Based on this ongoing process, accruals for environmental liabilities are established in accordance with SFAS No. 5. We estimate our environmental liabilities based on various assumptions and judgments, the specific nature of which varies in light of the particular facts and circumstances surrounding each environmental liability. These estimates typically reflect assumptions and judgments as to the probable nature, magnitude and timing of required investigation, remediation and monitoring activities and the probable cost of these activities, and in some cases reflect assumptions and judgments as to the obligation or willingness and ability of third parties to bear a proportionate or allocated share of the cost of these activities. Due to the numerous uncertainties and variables associated with these assumptions and judgments, and the effects of changes in governmental regulation and environmental technologies, both the precision and reliability of the resulting estimates of the related liabilities are subject to substantial uncertainties. We regularly monitor our estimated exposure to environmental liabilities and, as additional information becomes known, our estimates may change significantly. Our estimates of our environmental liabilities do not reflect potential future recoveries from insurance carriers except to the extent that recovery may from time to time be deemed probable as a result of a carrier's agreement to payment terms. In those instances in which our estimated exposure reflects actual or anticipated cost-sharing arrangements with third parties, we do not believe that we will be exposed to additional material liability as a result of non-performance by such third parties. Currently, we are not aware of any material environmental liabilities and have accrued for only specific minor environmental remediation costs we believe are likely to be incurred.

REVENUE RECOGNITION

We recognize revenue from product sales to our customers when title and risk of loss pass to the customer, which generally occurs upon shipment. In the case of export sales, title may not pass until the product reaches a foreign port.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 143, "Accounting for Asset Retirement Obligations," which is effective January 1, 2003. The Statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred, with the associated asset retirement costs capitalized as part of the carrying amount of the long-lived asset. We believe adoption of this Statement will not have a material adverse effect on our financial condition or results of operations.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." The Statement requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred, rather than at the commitment date of a plan. We adopted SFAS No. 146 in November 2002 and applied its provisions to our announced elimination of 106 salaried positions.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock Based Compensation - Transition and Disclosure," which amends SFAS No. 123, "Accounting for Stock Based Compensation." The Statement provides additional guidance in accounting and reporting for stock based compensation and was effective upon issuance. We have adopted the applicable provisions of SFAS No. 148 in this report.

1 RESTRICTED CASH

In June 2001, under the terms of our bank credit facility, we placed $96.6 million of the proceeds from borrowings under the credit facility into an interest-bearing escrow account. The escrow account's use was restricted to the repayment of our $100 million 6.25% Debentures, which occurred on March 15, 2002.

In September 2002, we placed $15.0 million into an interest-bearing escrow account under the terms of an amendment to our credit agreement. The escrow account's use is restricted to the repayment of $15 million of our medium-term notes, which mature on April 4, 2003.

2 RECEIVABLES, NET

The receivables balance at December 31, 2002 and 2001 includes approximately $22.3 million due to settlements reached with the Internal Revenue Service for the years 1989 through 1994. The settlements exceed the threshold amount that requires review by the congressional Joint Committee on Taxation. The review is currently in process.

3 INVENTORIES

(Dollars in thousands)	2002	2001
Logs, pulpwood, chips and sawdust	$ 25,212	$ 12,260
Lumber and other manufactured wood products	14,954	8,809
Pulp, paper and converted paper products	79,690	48,348
Materials and supplies	39,942	38,296
	$159,798	$107,713
Valued at lower of cost or market:		
Last-in, first-out basis	$ 36,125	$ 18,505
Average cost basis	123,673	89,208
	$159,798	$107,713

If the last-in, first-out inventory had been priced at lower of current average cost or market, the values would have been approximately $22.4 million higher at December 31, 2002, and $19.3 million higher at December 31, 2001. In 2002, reductions in quantities of LIFO inventories (primarily due to operations sold in 2002) valued at lower costs prevailing in prior years had the effect of increasing earnings, net of income taxes, by approximately $3.2 million ($.11 per common share).

4 PLANT AND EQUIPMENT

(Dollars in thousands)	2002	2001
Land improvements	$ 58,724	$ 59,433
Buildings and structures	283,585	282,701
Machinery and equipment	1,590,695	1,561,960
Other	56,890	56,890
Construction in progress	28,761	28,191
	$2,018,655	$1,989,175

Depreciation charged against income amounted to $84.5 million in 2002 ($85.1 million in 2001 and $83.4 million in 2000).

Authorized but unexpended appropriations for capital projects totaled $93.3 million at December 31, 2002, all of which is budgeted to be expended in 2003. We have capital commitments totaling approximately $45.0 million in 2003 related to our construction of a new tissue machine in Las Vegas, Nevada.

5 TIMBER, TIMBERLANDS AND RELATED LOGGING FACILITIES

(Dollars in thousands)	2002	2001
Timber and timberlands	$347,853	$348,287
Related logging facilities	48,573	47,381
	$396,426	$395,668

The cost of timber harvested from company-owned lands amounted to $10.6 million in 2002 ($8.9 million in 2001 and $8.3 million in 2000). The cost of permit timber harvested from non-company owned lands amounted to $15.8 million in 2002 ($14.8 million in 2001 and $14.3 million in 2000). Amortization of logging roads and related facilities amounted to $2.0 million in 2002 ($2.4 million in 2001 and $2.1 million in 2000).

6 OTHER ASSETS

(Dollars in thousands)	2002	2001
Pension assets	$ 81,582	$ 81,092
Other	23,636	27,119
	$105,218	$108,211

7 TAXES ON INCOME

The provision (benefit) for taxes on income is comprised of the following:

(Dollars in thousands)	2002	2001	2000
Current	$ 535	$ 438	$ 1,517
Deferred	(150,385)	(51,231)	(22,752)
Provision (benefit) for taxes on income	$(149,850)	$(50,793)	$(21,235)

The provision (benefit) for taxes on income differs from the amount computed by applying the statutory federal income tax rate of 35% to earnings before taxes on income due to the following:

(Dollars in thousands)	2002	2001	2000
Computed "expected" tax expense (benefit)	$(134,481)	$(45,583)	$(19,057)
State and local taxes, net of federal income tax benefits	(14,985)	(5,079)	(2,123)
All other items	(384)	(131)	(55)
Provision (benefit) for taxes on income	$(149,850)	$(50,793)	$(21,235)
Effective tax rate	39.0%	39.0%	39.0%

The tax effects of significant temporary differences creating deferred tax assets and liabilities at December 31 were:

(Dollars in thousands)	2002	2001
Plant and equipment	$(214,677)	$(358,766)
Timber, timberlands and related logging facilities	(53,341)	(50,154)
Postretirement benefits	68,794	63,522
Alternative minimum tax	43,867	58,235
Net operating loss carryforward	71,565	92,346
Employee benefits	19,108	19,250
Pensions	(3,709)	(21,601)
Discontinued operations	26,663	–
Other, net	10,300	12,805
Net deferred tax liability	(31,430)	(184,363)
Current deferred tax assets[1]	(25,224)	(26,247)
Net noncurrent deferred tax liabilities	$ (56,654)	$(210,610)

1 Included in "Prepaid expenses" in the Balance Sheets.

As of December 31, 2002 and 2001, we had $183.5 million and $236.8 million, respectively, of net operating loss carryforwards that will expire in 18 to 19 years. We expect that sufficient taxable income will be generated in the future to utilize these carryforwards and therefore have not provided any valuation allowance with respect to them.

Our federal income tax returns have been examined, and we have reached final settlement for all tax years through 1988. Settlements have been reached with the Internal Revenue Service for the years 1989 through 1994. The settlements exceed the threshold amount that requires review by the congressional Joint Committee on Taxation. The review is currently in process. The years 1995 through 2001 are currently under examination. In the opinion of management, adequate provision had been made at December 31, 2002, for income taxes that might be due as a result of these audits, and any resulting assessments will have no material effect on our consolidated earnings.

8 DEBT

(Dollars in thousands)	2002	2001
Revenue bonds fixed-rate 5.9% to 7.75% due 2002 through 2026	$171,628	$ 136,774
Revenue bonds variable rate due 2007 through 2030	–	99,892
Debentures 6.25% due 2002	–	99,996
Debentures 6.95% due 2015	22,469	99,851
Credit sensitive debentures 9.125% due 2009	100,000	100,000
Medium-term notes fixed-rate 8.27% to 9.46% due 2002 through 2022	94,050	164,500
Term loan variable rate due 2002 through 2005	–	199,000
Senior subordinated notes 10% due 2011	250,000	250,000
Other notes	105	112
	638,252	1,150,125
Less current installments on long-term debt	15,607	132,603
Less early maturing long-term debt	–	197,000
Long-term debt	$622,645	$ 820,522

In 2002, we retired $63.7 million of our variable rate revenue bonds, using proceeds from asset sales. In December 2002, we converted the remaining floating rate municipal bonds to fixed-rate bonds. The interest rates received on the converted bonds ranged from 6.125% to 7.75%. All other terms of the converted bonds remained identical to the variable rate version.

We repaid our 6.25% debentures due March 15, 2002, using the funds contained in an interest-bearing escrow account, which were restricted to that use.

The interest rate payable on the 9.125% credit sensitive debentures is subject to adjustment in accordance with the table below if certain changes in the debt rating of the debentures occur. In March 2001, Moody's adjusted its rating on our senior debt to Baa3 and in June 2001, Standard & Poor's (S&P) adjusted its rating to BBB-. Accordingly, the interest rate applied to the credit sensitive debentures increased from 9.125% to 9.425%. On January 30, 2003, S&P lowered its rating on our senior debt to BB+, causing the interest rate to increase from 9.425% to 12.5% effective that date.

Ratings

Moody's	S&P	Applicable Rate(%)
Aaa	AAA	8.825
Aa1 – Aa3	AA+ – AA-	8.925
A1 – Baa2	A+ – BBB	9.125
Baa3	BBB-	9.425
Ba1	BB+	12.500
Ba2	BB	13.000
Ba3	BB-	13.500
B1 or lower	B+ or lower	14.000

In June 2001, we obtained a new credit facility, which provided for aggregate borrowings up to $400.0 million in the form of a four-year term loan in the amount of $200.0 million and a three-year revolving line of credit of up to $200.0 million. Our obligations under the credit facility were secured by approximately 130,000 acres of our timberlands in Arkansas and our accounts receivable and inventory. On December 31, 2001, $199.0 million was outstanding under the four-year term loan and no borrowings were outstanding under the revolving line of credit. Upon consummation of the sale of the Printing Papers segment assets in May 2002, all outstanding amounts under our bank credit facility became due and payable, including the four-year term loan. Accordingly, amounts outstanding under the four-year term loan at December 31, 2001, of which $2.0 million was due within one year and $197.0 million was due in 2003 and later years, were classified as current liabilities. After repayment of the four-year term loan, that portion of the credit facility was no longer available to us. The revolving line of credit portion of the credit facility was reduced to $150.0 million on December 18, 2002, and at December 31, 2002, we had borrowed $40.0 million. As a result of an amendment to the credit facility negotiated after the repayment of the four-year term loan, borrowings under the credit facility are no longer secured by our Arkansas timberlands.

Our 10% senior subordinated notes due 2011 are unsecured and are subordinated to our senior notes and our credit facility.

Both the agreement covering our credit facility and the indenture governing our senior subordinated notes contain certain covenants that, among other things, restrict our ability and our subsidiaries' ability to create liens, merge or consolidate, dispose of assets, incur indebtedness, pay dividends, repurchase or redeem capital stock and indebtedness, make certain investments or acquisitions, make capital expenditures, or change the nature of our business. Our credit facility also contains financial maintenance covenants. We have obtained an amendment to our credit facility modifying the interest coverage ratio calculation, and as a result of this modification, we were in compliance with the covenants of our credit facility as of December 31, 2002.

In December 2001, we entered into a fixed-to-variable interest rate swap to hedge a portion of our 10% senior subordinated debentures. The swap has been designated as a fair value hedge and calls for the company to pay a variable interest amount, based on LIBOR rates, and receive a fixed-rate payment from a financial institution, calculated on $165.0 million of our 10% senior subordinated debentures. We assume there is no ineffectiveness in the hedge and, accordingly, a fair value increase

or decrease in the swap is offset by a corresponding decrease or increase in the value of the underlying debt instrument.

Payments due on long-term debt during each of the five years subsequent to December 31, 2002, are as follows:

(Dollars in thousands)	
2003	$15,607
2004	607
2005	1,608
2006	2,958
2007	6,759

9 ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

(Dollars in thousands)	2002	2001
Trade accounts payable	$ 44,371	$ 37,184
Accrued wages, salaries and employee benefits	51,015	45,369
Accrued taxes other than taxes on income	11,066	11,977
Accrued interest	15,005	19,710
Accrued taxes on income	13,059	15,233
Book overdrafts	16,030	25,982
Accrued restructuring, mill closure and divestiture charges	8,659	1,203
Other	30,247	33,258
	$189,452	$189,916

10 OTHER LONG-TERM OBLIGATIONS

(Dollars in thousands)	2002	2001
Postretirement benefits	$176,394	$162,877
Pension and related liabilities	69,747	22,795
Other	15,024	9,586
	$261,165	$195,258

11 DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

Estimated fair values of our financial instruments are as follows:

	2002		2001	
(Dollars in thousands)	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash, restricted cash and short-term investments	$ 26,042	$ 26,042	$ 136,184	$ 136,184
Current notes payable	40,000	40,000	–	–
Long-term debt	638,252	659,818	1,150,125	1,160,243
Interest rate swaps	8,491	8,491	1,294	1,294

For short-term investments, current notes payable and interest rate swaps, the carrying amount approximates fair value. The fair value of our long-term debt is estimated based upon the quoted market prices for the same or similar debt issues. The amount of long-term debt for which there is no quoted market price is immaterial and the carrying amount approximates fair value.

12 RETIREMENT, SAVINGS AND OTHER POSTRETIREMENT BENEFIT PLANS

Substantially all of our employees are eligible to participate in 401(k) savings plans and are covered by noncontributory defined benefit pension plans. These include both company-sponsored and multi-employer plans. In 2002, 2001 and 2000 we made matching 401(k) contributions on behalf of employees of $7.3 million, $8.9 million and $9.8 million, respectively. We also provide benefits under company-sponsored defined benefit retiree health care and life insurance plans, which cover certain salaried and hourly employees. Most of the retiree health care plans require retiree contributions and contain other cost sharing features. The retiree life insurance plans are primarily noncontributory.

The change in benefit obligation, change in plan assets, funded status and related balance sheet amounts for company-sponsored benefit plans are as follows:

	Pension Benefit Plans		Other Postretirement Benefit Plans	
(Dollars in thousands)	2002	2001	2002	2001
Benefit obligation at beginning of year	$527,039	$510,763	$ 219,129	$ 172,799
Service cost	10,605	13,178	3,723	3,243
Interest cost	36,979	35,754	16,205	12,942
Plan amendments	2,560	829	–	(1,045)
Actuarial losses (gains)	16,619	(1,475)	37,084	38,018
Curtailments	–	–	(18,272)	5,372
Special termination benefits	–	–	–	317
Mergers, sales and closures	(30,603)	2,835	–	–
Benefits paid	(38,092)	(34,845)	(15,456)	(12,517)
Benefit obligation at end of year	525,107	527,039	242,413	219,129
Fair value of plan assets at beginning of year	615,269	666,906	22,198	35,413
Actual return on plan assets	(67,821)	(19,458)	(3,909)	(3,084)
Employer contribution	1,215	2,666	–	–
Mergers, sales and closures	(39,181)	–	–	–
Benefits paid	(38,092)	(34,845)	(8,476)	(10,131)
Fair value of plan assets at end of year	471,390	615,269	9,813	22,198
Funded status	(53,717)	88,230	(232,600)	(196,931)
Unrecognized prior service cost (benefit)	16,411	29,347	(8,614)	(9,254)
Unrecognized net loss (gain)	109,399	(53,270)	64,820	43,308
Unrecognized net transition asset	(37)	(75)	–	–
Prepaid (accrued) benefit cost	$ 72,056	$ 64,232	$(176,394)	$(162,877)

The projected benefit obligation, accumulated benefit obligation and value of plan assets for the pension plans with accumulated benefit obligations in excess of plan assets were $262.4 million, $259.1 million and $196.5 million, respectively, at December 31, 2002, and $36.9 million, $33.2 million and $18.7 million, respectively, at December 31, 2001.

As of December 31, 2002, $70.6 million of minimum pension liabilities for underfunded plans was included in other long-term liabilities, with corresponding intangible assets of $16.2 million and a charge of $33.2 million to stockholders' equity, which is net of deferred taxes of $21.2 million. As of December 31, 2001, minimum pension liabilities totaled $2.2 million, with corresponding intangible assets of the same amount.

Net periodic costs (benefit) were:

	Pension Benefit Plans			Other Postretirement Benefit Plans		
(Dollars in thousands)	2002	2001	2000	2002	2001	2000
Service cost	$ 10,605	$ 13,178	$ 13,944	$ 3,723	$ 3,243	$ 3,360
Interest cost	36,979	35,754	34,181	16,205	12,942	11,641
Expected return on plan assets	(62,686)	(60,453)	(55,553)	(1,620)	(2,847)	(3,691)
Amortization of prior service cost	2,296	3,356	3,075	(820)	(833)	(717)
Recognized actuarial loss (gain)	(5,037)	(5,378)	(3,586)	2,790	–	–
Recognized net initial asset	(37)	(45)	(172)	–	–	–
Other	–	–	–	–	–	58
Net periodic cost (benefit)	$(17,880)	$(13,588)	$ (8,111)	$20,278	$12,505	$10,651

The pension benefits presented above exclude an estimated cost of $.2 million for a salaried workforce reduction in 2002, a cost of $2.7 million in 2001 for an hourly workforce reduction program and $1.9 million in 2000 for a salaried workforce reduction program and a mill closure, which are included in "Restructuring and other charges" in the Statements of Operations. The postretirement costs presented above exclude an estimated cost of $2.0 million for a salaried workforce reduction in 2002, $.5 million in 2001 for an hourly workforce reduction program and $3.9 million in 2000 for a salaried workforce reduction program, which are included in "Restructuring and other charges" in the Statements of Operations.

The pension benefits presented above also do not reflect a cost of $11.0 million related to the sale of Printing Papers segment assets and subsequent closure of a printing papers facility, as well as $.2 million for the sale of a lumber mill. Postretirement costs of $.2 million and $.2 million, respectively, as a result of these events are also excluded from the costs presented above. The combined costs of $11.6 million are included in "Loss from discontinued operations."

Due to our recent exit from the coated printing papers business and the resulting reduction in the number of salaried and hourly employees, we believe that our relative costs should decline in the future for pension and postretirement benefits.

Weighted average assumptions as of December 31 were:

	Pension Benefit Plans			Other Postretirement Benefit Plans		
	2002	2001	2000	2002	2001	2000
Discount rate	6.75%	7.25%	7.25%	6.75%	7.25%	7.25%
Expected return on plan assets	9.50	9.50	9.50	9.00	9.00	9.00
Rate of salaried compensation increase	4.00	5.00	5.00	–	–	–

The health care cost trend rate assumption used in determining the accumulated postretirement benefit obligation is 9.00% for 2002. The rate is assumed to decrease one percent annually to 6.00% in 2005 and remain at that level thereafter. This assumption has a significant effect on the amounts reported. A one percentage point change in the health care cost trend rates would have the following effects:

(Dollars in thousands)	1% Increase	1% Decrease
Effect on total of service and interest cost components	$ 2,650	$ (2,212)
Effect on postretirement benefit obligation	27,393	(23,272)

Hourly employees at two of our manufacturing facilities participate in a multi-employer defined benefit pension plan, the Paper, Allied-Industrial, Chemical and Energy Workers International Union (PACE) Pension Fund, to which we make contributions. We also make contributions to a trust fund established to provide retiree medical benefits for these employees, which is managed by PACE. Company contributions to these plans in 2002, 2001 and 2000 amounted to $6.2 million, $6.1 million and $5.2 million, respectively.

13 STOCK COMPENSATION PLANS

We currently have three fixed stock option plans under which options are issued and outstanding. All of these plans have received shareholder approval. Options are granted with an exercise price equal to market value at the grant date and prior to 1995 may have included a stock appreciation right. Options may also be issued in the form of restricted stock and other share-based awards, none of which were outstanding at December 31, 2002. Options are fully exercisable after two years and expire not later than 10 years from the date of grant. We were originally authorized to issue up to 1.5 million shares, 1.7 million shares and 1.4 million shares under our 1989 Stock Incentive Plan, 1995 Stock Incentive Plan and 2000 Stock Incentive Plan, respectively. At December 31, 2002, no shares were available for future use under the 1989 Stock Incentive Plan, while approximately 5,000 shares and 789,000 shares were authorized for future use under the 1995 and 2000 Stock Incentive Plans, respectively.

A summary of the status of our stock options as of December 31, 2002, 2001 and 2000 and changes during those years is presented below:

	2002		2001		2000	
Options	Shares	Weighted Avg. Exercise Price	Shares	Weighted Avg. Exercise Price	Shares	Weighted Avg. Exercise Price
Outstanding at January 1	2,993,000	$38.63	2,664,025	$40.41	2,529,850	$41.97
Granted	378,300	24.87	488,275	28.69	469,575	32.06
Shares exercised	(25,050)	32.06	(750)	32.63	(18,900)	29.96
SARs exercised	–	–	(4,050)	32.63	(16,400)	30.37
Canceled or expired	(509,893)	39.67	(154,500)	38.08	(300,100)	41.65
Outstanding at December 31	2,836,357	36.67	2,993,000	38.63	2,664,025	40.41
Options exercisable	2,263,594	39.33	2,287,312	41.38	1,984,437	42.29
Options outstanding which include a stock appreciation right	78,600		120,350		142,225	
Shares reserved for future grants	793,963		834,145		1,248,680	
Fair value of options granted during the year	$7.20		$10.02		$5.77	

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used for grants in 2002, 2001 and 2000, respectively: dividend yield of 2.41, 2.09 and 5.43 percent; stock volatility of .2538, .275 and .2707; risk free rate of return of 4.17, 5.28 and 5.21 percent; and expected term of 10 years for all grants.

The following table summarizes information about stock options outstanding at December 31, 2002:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at 12/31/02	Weighted Avg. Remaining Contractual Life	Weighted Avg. Exercise Price	Number Exercisable at 12/31/02	Weighted Avg. Exercise Price
$23.88 to $29.32	775,850	9.49 years	$26.82	203,087	$28.69
$32.06 to $37.75	813,857	6.04 years	34.93	813,857	34.93
$41.25 to $48.25	1,246,650	4.44 years	43.93	1,246,650	43.93
$23.88 to $48.25	2,836,357	6.28 years	36.67	2,263,594	39.33

14 SEGMENT INFORMATION

As of December 31, 2002, our operations were divided into three reporting segments: Resource, Wood Products and Pulp and Paper, based upon similarities in product lines, manufacturing processes, marketing and management of our businesses. The Resource segment manages our timberland base, provides wood fiber to the manufacturing segments and sells wood fiber to third parties. The Wood Products segment produces oriented strand board, lumber, plywood and particleboard. The Pulp and Paper segment produces paperboard, consumer tissue and pulp. As a result of management changes effective in January 2003, the Pulp and Paper segment was split into two separate business segments, the Consumer Products segment and the Pulp and Paperboard segment. In 2003, results for these two segments will be reported separately, with prior year amounts reclassified for comparative purposes.

We exited our Printing Papers segment in May 2002 when a majority of the segment's assets were sold to a domestic subsidiary of Sappi Limited. We also closed and sold a hardwood sawmill during the third quarter of 2002. Prior year amounts presented in the tables below have been adjusted for these discontinued operations.

The reporting segments follow the same accounting policies used for our consolidated financial statements and described in the summary of significant accounting policies with the exception of the valuation of inventories. All segment inventories are reported using the average cost method and the LIFO reserve is recorded at the corporate level. Management evaluates a segment's performance based upon profit or loss from operations before income taxes. Intersegment sales or transfers are recorded based on prevailing market prices.

Following is a tabulation of business segment information for each of the past three years. Corporate information is included to reconcile segment data to the consolidated financial statements.

(Dollars in thousands)	2002	2001	2000
Segment Sales:			
Resource	$ 404,504	$ 405,810	$ 352,324
Wood products:			
Oriented strand board	187,293	167,182	208,067
Lumber	249,790	251,891	232,137
Plywood	34,915	40,529	51,550
Particleboard	14,083	15,833	19,481
Other	23,077	26,858	27,680
	509,158	502,293	538,915
Pulp and paper:			
Paperboard	395,085	420,588	426,537
Tissue	315,662	317,696	282,625
Pulp	14,659	13,426	20,906
	725,406	751,710	730,068
	1,639,068	1,659,813	1,621,307
Elimination of intersegment sales	(352,851)	(385,228)	(328,114)
Total consolidated net sales	$1,286,217	$1,274,585	$1,293,193
Intersegment Sales or Transfers:[1]			
Resource	$ 339,169	$ 367,737	$ 315,116
Wood products	12,489	17,450	12,948
Pulp and paper	1,193	41	50
Total	$ 352,851	$ 385,228	$ 328,114
Operating Income (Loss):			
Resource	$ 62,554	$ 55,337	$ 61,395
Wood products	(27,031)	(26,562)	(17,046)
Pulp and paper	(15)	(14,473)	12,929
Eliminations and adjustments	(3,389)	2,058	1,534
	32,119	16,360	58,812
Corporate Items:			
Administration expense	(37,872)	(35,222)	(25,664)
Interest expense	(59,882)	(77,853)	(59,438)
Other, net	(17,862)	3,984	(28,452)
Consolidated loss before taxes on income	$ (83,497)	$ (92,731)	$ (54,742)

(Dollars in thousands)	2002	2001	2000
Depreciation, Amortization and Cost of Fee Timber Harvested:			
Resource	$ 28,791	$ 26,527	$ 25,260
Wood products	30,591	30,530	26,978
Pulp and paper	52,894	53,745	55,383
	112,276	110,802	107,621
Corporate	3,193	4,231	1,101
Total	$ 115,469	$ 115,033	$ 108,722
Assets:			
Resource	$ 432,036	$ 434,293	$ 430,583
Wood products	353,693	357,581	293,741
Pulp and paper	677,749	663,909	751,980
	1,463,478	1,455,783	1,476,304
Assets held for sale	5,000	772,033	839,411
Corporate	147,848	259,330	226,730
Total consolidated assets	$1,616,326	$2,487,146	$2,542,445
Capital Expenditures:			
Resource	$ 15,346	$ 14,132	$ 20,499
Wood products	8,520	14,572	73,480
Pulp and paper	27,418	13,898	48,200
	51,284	42,602	142,179
Corporate	330	77	633
Total	$ 51,614	$ 42,679	$ 142,812

1 Intersegment sales for 2000-2002, which were based on prevailing market prices, consisted primarily of logs, chips, pulp logs and other fiber sales by our Resource segment to the Wood Products, Printing Papers and Pulp and Paper segments.

All of our manufacturing facilities and all other assets are located within the continental United States. However, we sell and ship products to many foreign countries. Geographic information regarding our net sales is summarized as follows:

(Dollars in thousands)	2002	2001	2000
United States	$1,189,825	$1,189,660	$1,171,091
Japan	48,224	33,771	51,713
Australia	4,881	4,378	7,245
Canada	9,090	8,731	11,185
China	12,303	9,327	22,135
Italy	6,543	7,450	9,510
Korea	11,210	13,501	8,031
Other foreign countries	4,141	7,767	12,283
Total consolidated net sales	$1,286,217	$1,274,585	$1,293,193

15 RESTRUCTURING AND OTHER CHARGES

The following is a description of the charges included in the "Restructuring and other charges" line in the Statements of Operations.

In 2002 we recorded a $9.0 million pre-tax charge for costs associated with the elimination of 106 salaried production and administrative positions. We expect to record an additional $.4 million during the first half of 2003 for costs related to terminated employees whose services have been retained beyond the initial 60-day period following the announced job eliminations, as required by SFAS No. 146. As of December 31, 2002, 82 employees had been terminated, three had assumed other positions within the company as a result of job openings, and 21 were scheduled for termination in the first half of 2003. We have recorded $3.8 million against the accrued liability associated with the charge at December 31, 2002. We expect to pay all material costs related to the reduction, which consists of severance compensation and employee benefits, by the end of the first half of 2003.

In March 2001, we recorded a $4.2 million pre-tax charge associated with a workforce reduction program at our pulp, paperboard and consumer products operations in Idaho. In September 2001, an additional $.4 million pre-tax charge was recorded as a result of final cost determinations for pension and medical benefits. The program permanently reduced the workforce by 124 hourly production and maintenance positions. As of December 31, 2001, all material costs associated with the program, which consisted of cash payments and employee benefits, had been incurred.

In 2000 we recorded a $27.9 million pre-tax charge to cover costs associated with a company-wide reduction and reorganization of our salaried production and administrative workforce. In establishing the liability, we estimated 261 employees would be terminated. As of December 31, 2001, a total of 273 employees had been terminated under the reduction and reorganization program. As of December 31, 2002, all costs associated with the workforce reduction program, which consisted of severance compensation and employee benefits, had been incurred.

In September 2000, we recorded an $18.5 million pre-tax charge for costs associated with the closure of our Jaype, Idaho, plywood mill. As of December 31, 2001, a total of five salaried and 207 hourly production and maintenance employees had been terminated due to the closure. The mill was dismantled in 2001, with equipment and parts used at our other facilities or sold to outside bidders. As of December 31, 2001, $16.5 million had been recorded against the accrued liability associated with the charge, which represented all material costs we expected to incur. Our initial estimate of the cost to close the mill included expected costs for some aspects of maintenance and demolition that were not incurred. As a result, in December 2001, we reversed $1.8 million of the liability and recorded it as income.

16 OTHER INCOME (EXPENSE), NET

(Dollars in thousands)	2002	2001	2000
Interest income	$ 1,939	$ 2,569	$ 192
Sale of timber and timberlands	6,297	3,933	2,212
Beloit Corporation charge	–	(11,116)	–
Other	6,966	2,393	(5,405)
	$15,202	$ (2,221)	$(3,001)

17 DISCONTINUED OPERATIONS

On March 18, 2002, we announced that we had signed a definitive agreement with a domestic subsidiary of Sappi Limited for the sale of our Cloquet, Minnesota, pulp and printing papers facilities and certain associated assets for $485.5 million in cash, after closing adjustments. The sale was completed in May 2002. As a result of the transaction, we recorded an after-tax charge of $149.8 million in the first quarter of 2002. The charge represented estimated costs associated with the write-down of the carrying value of the assets involved in the sale and closure of the Brainerd facility, as well as other costs associated with exiting the coated paper business. In December 2002, we recorded an additional after-tax charge of $14.6 million to adjust employee severance costs, the carrying value of the remaining Brainerd assets and other exit costs. The charges and year-to-date operating losses of $13.9 million,

after tax, are presented as discontinued operations in the Statements of Operations, as required by SFAS No. 144.

In conjunction with the sale, we closed our Brainerd printing papers mill. In late October 2002 we entered into a memorandum of understanding with a buyer for the sale of the Brainerd facility. The facility was sold on February 28, 2003 for $4.44 million in cash.

On June 3, 2002, we announced that we would close our Bradley hardwood mill in Warren, Arkansas, and exit the hardwood lumber business. We sold the facility in August 2002. An initial after-tax charge of $5.7 million was recorded for estimated asset write-down and closure costs. In December 2002, we reversed $1.6 million of the initial charge, after tax, to reflect actual costs incurred for the closure and sale. The net charge and year-to-date operating losses of $1.0 million, after tax, are also presented as discontinued operations in the Statements of Operations, as required by SFAS No. 144.

The assets and liabilities of the Printing Papers segment and the Bradley lumber mill are presented in the Balance Sheets under the captions "Assets held for sale" and "Liabilities related to assets held for sale." The carrying amounts of the major classes of these assets and liabilities at December 31 were as follows:

(Dollars in thousands)	2002	2001
Assets:		
Cash	$ –	$ 292
Receivables, net	–	40,715
Inventories	–	76,858
Land, other than timberlands	108	374
Plant and equipment, net	4,892	653,785
Other assets	–	9
Total assets held for sale	$5,000	$772,033
Liabilities:		
Accounts payable and accrued liabilities	$ 12	$ 33,933

18 FINANCIAL RESULTS BY QUARTER (UNAUDITED)

(Dollars in thousands – except per-share amounts)	Three Months Ended							
	March 31		June 30		September 30		December 31	
	2002	2001	2002	2001	2002	2001	2002	2001*
Net sales	$318,189	$312,872	$333,178	$335,026	$324,060	$337,903	$310,790	$288,784
Costs and expenses:								
Depreciation, amortization and cost of fee timber harvested	30,484	27,242	27,244	27,630	29,067	30,270	28,674	29,891
Materials, labor and other operating expenses	273,140	293,821	278,119	276,392	271,910	269,599	278,896	243,329
Selling, general and administrative expenses	22,019	20,194	20,928	20,848	20,814	22,037	19,416	23,239
Restructuring and other charges	–	4,217	–	–	–	353	8,963	(1,820)
	325,643	345,474	326,291	324,870	321,791	322,259	335,949	294,639
Earnings (loss) from operations	$ (7,454)	$ (32,602)	$ 6,887	$ 10,156	$ 2,269	$ 15,644	$ (25,159)	$ (5,855)
Loss from discontinued operations, net of tax	$(152,443)	$ (1,590)	$ (13,532)	$ (5,884)	$ (2,051)	$ (4,262)	$ (15,422)	$ (11,143)
Net loss	$(167,381)	$ (31,408)	$ (20,089)	$ (9,789)	$ (12,433)	$ (6,551)	$ (34,478)	$ (31,697)
Net loss per common share:								
Basic	$(5.90)	$(1.11)	$(.70)	$(.35)	$(.43)	$(.23)	$(1.20)	$(1.12)
Diluted	(5.90)	(1.11)	(.70)	(.35)	(.43)	(.23)	(1.20)	(1.12)

*Includes an $11.1 million pre-tax charge related to Beloit Corporation and a $2.2 million pre-tax charge related to the insolvency of a pulp broker.

THE BOARD OF DIRECTORS:

We have audited the accompanying balance sheets of Potlatch Corporation and consolidated subsidiaries as of December 31, 2002 and 2001 and the related statements of operations and comprehensive loss, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2002. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion the financial statements referred to above present fairly, in all material respects, the financial position of Potlatch Corporation and consolidated subsidiaries as of December 31, 2002 and 2001 and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP
Portland, Oregon
January 24, 2003

ELEVEN-YEAR RECORD

ELEVEN-YEAR RECORD

For the years ended December 31 (Dollars in thousands – except per-share amounts)	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
ELEVEN-YEAR SUMMARY OF CONSOLIDATED OPERATIONS											
Net sales	$1,286,217	$1,274,585	$1,293,193	$1,343,773	$1,243,506	$1,693,371	$1,675,756	$1,721,774	$1,546,153	$1,436,236	$1,392,842
Costs and expenses:											
Depreciation, amortization and cost of fee timber harvested	115,469	115,033	108,722	107,481	108,101	149,785	141,521	137,031	138,251	123,544	107,165
Materials, labor and other operating expenses	1,102,065	1,083,141	1,044,894	1,007,502	952,394	1,344,166	1,307,434	1,274,570	1,196,386	1,131,642	1,073,117
Selling, general and administrative expenses	83,177	86,318	85,469	98,663	96,311	106,450	104,114	90,569	82,799	83,958	83,409
Restructuring and other charges	8,963	2,750	46,411	–	–	–	–	–	–	–	–
	1,309,674	1,287,242	1,285,496	1,213,646	1,156,806	1,600,401	1,553,069	1,502,170	1,417,436	1,339,144	1,263,691
Earnings (loss) from operations	(23,457)	(12,657)	7,697	130,127	86,700	92,970	122,687	219,604	128,717	97,092	129,151
Interest expense	(59,882)	(77,853)	(59,438)	(45,442)	(49,744)	(46,124)	(43,869)	(47,976)	(51,137)	(46,230)	(34,902)
Other income (expense), net	(158)	(2,221)	(3,001)	(475)	8,991	7,789	7,508	(689)	(1,619)	14,142	30,365
Earnings (loss) before taxes on income, cumulative effect of accounting changes and extraordinary item	(83,497)	(92,731)	(54,742)	84,210	45,947	54,635	86,326	170,939	75,961	65,004	124,614
Provision (benefit) for taxes on income	(32,564)	(36,165)	(21,349)	32,000	16,541	18,576	24,792	62,393	26,966	26,665	45,700
Tax rate	39.0%	39.0%	39.0%	38.0%	36.0%	34.0%	28.7%	36.5%	35.5%	41.0%	36.7%
Earnings (loss) from continuing operations before cumulative effect of accounting changes and extraordinary item	(50,933)	(56,566)	(33,393)	52,210	29,406	36,059	61,534	108,546	48,995	38,339	78,914
Cumulative effect of accounting changes, net of tax	–	–	–	–	–	–	–	–	–	(50,292)	–
Extraordinary item, net of tax	–	–	–	–	–	–	(3,445)	–	–	–	–
Discontinued operations, net of tax	(183,448)	(22,879)	179	(11,263)	7,826	–	–	–	–	–	–
Net earnings (loss)	$ (234,381)	$ (79,445)	$ (33,214)	$ 40,947	$ 37,232	$ 36,059	$ 58,089	$ 108,546	$ 48,995	$ (11,953)	$ 78,914
FINANCIAL RETURNS											
Percent return on beginning of the year common stockholders' equity[1]	(33.1)%	(9.8)%	(3.6)%	4.4%	3.9%	3.8%	6.2%	12.0%	5.4%	4.0%	8.6%
Percent return on net sales[1]	(18.2)%	(6.2)%	(2.6)%	3.0%	3.0%	2.1%	3.5%	6.3%	3.2%	2.7%	5.7%
PER COMMON SHARE											
Basic net earnings (loss)[1]	$ (8.23)	$ (2.81)	$ (1.16)	$ 1.41	$ 1.28	$ 1.25	$ 2.01	$ 3.72	$ 1.68	$ 1.31	$ 2.71
Net cash provided by operations	$ (2.43)	$ 1.22	$ 2.54	$ 6.61	$ 5.02	$ 5.35	$ 7.78	$ 8.49	$ 6.26	$ 5.90	$ 5.04
Cash dividends	$ .60	$ 1.17	$ 1.74	$ 1.74	$ 1.74	$ 1.71	$ 1.67	$ 1.615	$ 1.57	$ 1.515	$ 1.425
Common stockholders' equity at year end	$ 15.07	$ 24.98	$ 28.69	$ 31.79	$ 32.19	$ 32.82	$ 33.06	$ 32.59	$ 30.85	$ 30.86	$ 32.79
COMMON SHARES (IN THOUSANDS)											
Average shares outstanding	28,462	28,282	28,523	28,947	29,000	28,930	28,888	29,157	29,217	29,184	29,110
Outstanding at year end, net of treasury stock	28,579	28,311	28,346	28,972	28,919	28,995	28,866	28,962	29,224	29,199	29,144
APPROXIMATE NUMBER OF COMMON STOCKHOLDERS AT YEAR END	1,900	2,900	3,100	3,200	3,400	3,600	3,700	3,300	3,500	3,600	3,600
PRICE RANGE OF COMMON STOCK											
High	$ 36.13	$ 36.22	$ 44.88	$ 45.50	$ 48.38	$ 52.75	$ 44.88	$ 44.13	$ 49.50	$ 51.88	$ 50.00
Low	$ 23.88	$ 24.90	$ 28.56	$ 32.50	$ 31.00	$ 39.00	$ 35.13	$ 37.13	$ 35.50	$ 38.25	$ 36.75
EMPLOYMENT											
Approximate number of employees at year end	4,300	6,300	6,500	7,000	6,800	6,700	6,700	6,600	6,700	7,000	7,000
Wages, salaries and cost of employee benefits	$ 309,032	$ 308,343	$ 325,417	$ 332,973	$ 312,972	$ 417,422	$ 410,052	$ 405,016	$ 391,160	$ 389,597	$ 376,537
SELECTED PRODUCTION STATISTICS (IN THOUSANDS)											
Oriented strand board (square feet, 3/8" basis)	1,282,000	1,134,000	1,096,000	1,101,000	1,077,000	977,000	1,017,000	1,063,000	1,080,000	1,078,000	1,066,000
Lumber, domestic (board feet, dry)	688,000	685,000	616,000	590,000	561,000	534,000	491,000	441,000	408,000	420,000	406,000
Plywood, domestic (square feet, 3/8" basis)	123,000	141,000	172,000	222,000	191,000	254,000	240,000	289,000	298,000	312,000	331,000
Particleboard (square feet, 3/4" basis)	63,000	67,000	69,000	70,000	69,000	67,000	63,000	67,000	67,000	64,000	68,000
Pulp (air-dry tons)	768	716	732	741	747	899	878	873	816	811	845
Paperboard (tons)	629	596	593	596	620	614	575	582	549	545	563
Tissue paper (tons)	174	175	169	162	154	150	143	144	135	131	86

1 The 1993 return on equity, return on sales and loss per share after accounting changes were (1.2)%, (.8)% and $(.41), respectively.

Note: Certain 2001-1998 amounts have been restated to conform to the 2002 presentation.

ELEVEN-YEAR RECORD

At December 31
(Dollars in thousands)

	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
ELEVEN-YEAR SUMMARY OF CONSOLIDATED FINANCIAL POSITION											
Current assets	$ 347,764	$1,165,836	$1,184,151	$1,144,749	$ 997,509	$ 403,777	$ 378,111	$ 477,249	$ 371,318	$ 327,153	$ 331,845
Current liabilities	245,071	553,452	439,099	364,746	310,299	297,556	260,145	349,183	228,590	198,015	178,308
Working capital	102,693	612,384	745,052	780,003	687,210	106,221	117,966	128,066	142,728	129,138	153,537
Capital assets, at cost:											
Plant and equipment, net	758,168	808,763	937,415	888,190	917,959	1,493,417	1,465,682	1,356,020	1,313,939	1,340,028	1,311,946
Timber, timberlands and logging facilities, net	396,426	395,668	333,249	335,194	338,617	342,503	349,466	352,321	346,199	343,044	279,669
Unexpended revenue bond funds	–	–	–	–	335	814	2,625	23,545	–	1,395	55
Other noncurrent assets, net	113,968	116,879	87,630	78,367	122,886	124,625	69,795	56,176	49,773	74,032	92,232
Total net assets	$1,371,255	$1,933,694	$2,103,346	$2,081,754	$2,067,007	$2,067,580	$2,005,534	$1,916,128	$1,852,639	$1,887,637	$1,837,439
CAPITALIZATION											
Long-term debt (noncurrent portion)	$ 622,645	$ 820,522	$ 801,549	$ 701,798	$ 712,113	$ 722,080	$ 672,048	$ 616,132	$ 633,473	$ 707,131	$ 634,209
Other long-term obligations	261,165	195,258	184,147	172,986	163,453	155,336	148,092	145,022	147,877	120,388	22,299
Deferred taxes	56,654	210,610	293,961	275,644	253,691	236,934	223,441	198,823	169,670	159,042	225,350
Put options	–	–	10,453	10,287	6,844	1,638	7,758	12,247	–	–	–
Stockholders' equity	430,791	707,304	813,236	921,039	930,906	951,592	954,195	943,904	901,619	901,076	955,581
Total capitalization	$1,371,255	$1,933,694	$2,103,346	$2,081,754	$2,067,007	$2,067,580	$2,005,534	$1,916,128	$1,852,639	$1,887,637	$1,837,439

For the years ended December 31
(Dollars in thousands)

	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
ELEVEN-YEAR SUMMARY OF CONSOLIDATED FUNDS FLOW											
SOURCE OF FUNDS											
Net earnings (loss)	$ (234,381)	$ (79,445)	$ (33,214)	$ 40,947	$ 37,232	$ 36,059	$ 58,089	$ 108,546	$ 48,995	$ (11,953)	$ 78,914
Depreciation, amortization and cost of fee timber harvested	115,469	115,033	108,722	107,481	108,101	149,785	141,521	137,031	138,251	123,544	107,165
Deferred taxes	(153,956)	(83,351)	18,317	21,953	16,757	13,493	24,618	29,153	10,628	18,069	7,291
Proceeds from long-term debt	–	450,000	100,000	99,935	–	50,000	197,543	124,785	–	79,525	75,124
Issuance of treasury stock	8,146	6,620	952	1,250	550	2,985	722	193	542	1,181	2,366
Decrease (increase) in investments of unexpended revenue bond funds	–	–	–	335	479	1,811	20,920	(23,545)	1,395	(1,340)	2,375
Decrease (increase) in working capital other than cash and short-term investments	596,549	61,186	34,099	(96,721)	(39,063)	14,971	(87,738)	69,009	14,983	19,312	(34,354)
Total source of funds	331,827	470,043	228,876	175,180	124,056	269,104	355,675	445,172	214,794	228,338	238,881
APPLICATION OF FUNDS											
Dividends	17,071	33,108	49,698	50,362	50,472	49,462	48,254	47,096	45,870	44,214	41,476
Additions to plant and properties	51,614	42,679	142,812	65,277	58,544	158,485	239,908	170,654	104,389	201,655	179,539
Reduction of long-term debt	394,877	234,027	249	110,250	9,967	–	141,627	142,126	73,658	6,603	3,929
Purchase of treasury stock	–	10,453	25,892	–	3,261	–	5,042	11,285	–	–	–
Increase (decrease) in investments	2,343	2,428	3,143	(49,174)	25	50,004	48	773	(33,557)	(18,828)	9,911
Other, net	(23,936)	21,830	7,934	2,393	870	7,927	18,634	18,891	(4,139)	(219)	12,575
Total application of funds	441,969	344,525	229,728	179,108	123,139	265,878	453,513	390,825	186,221	233,425	247,430
Increase (decrease) in funds	$ (110,142)	$ 125,518	$ (852)	$ (3,928)	$ 917	$ 3,226	$ (97,838)	$ 54,347	$ 28,573	$ (5,087)	$ (8,549)

Note: Certain 2001-1998 amounts have been restated to conform to the 2002 presentation.

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

DIRECTORS

BOH A. DICKEY[1][3]
Retired President and
Chief Operating Officer
SAFECO Corporation
Seattle, Washington

JEROME C. KNOLL[1][2]
Vice President
Genie Industries, Inc.
Redmond, Washington

LAWRENCE S. PEIROS
Group Vice President
The Clorox Company
Oakland, California

GREGORY L. QUESNEL[1][2][4]
President and Chief
Executive Officer
CNF, Inc.
Palo Alto, California

TONI REMBE[3][4]
Partner
Pillsbury Winthrop LLP
San Francisco, California

MICHAEL T. RIORDAN
Former Chairman,
Chief Executive Officer
and President
Paragon Trade Brands, Inc.;
Former Chairman,
President and
Chief Executive Officer
Fort Howard Corporation
Green Bay, Wisconsin

JUDITH M. RUNSTAD[2][4]
Of counsel,
Foster Pepper & Shefelman
PLLC
Seattle, Washington

L. PENDLETON SIEGEL[3]
Chairman of the Board and
Chief Executive Officer

FREDERICK T. WEYERHAEUSER[2][4]
Retired Chairman of the Board
and Treasurer
Clearwater Investment Trust
Saint Paul, Minnesota

DR. WILLIAM T. WEYERHAEUSER[2][3]
Chairman
Columbia Banking System, Inc.;
Chairman
Eden Bioscience Corporation
Tacoma, Washington

COMMITTEES OF THE BOARD
1. Audit Committee
2. Executive Compensation and Personnel Policies Committee
3. Finance Committee
4. Nominating and Corporate Governance Committee

PRINCIPAL OFFICERS*

L. PENDLETON SIEGEL
Chairman of the Board and
Chief Executive Officer
Age 60/With company
23 years

RICHARD L. PAULSON
President and Chief
Operating Officer
Age 61/With company
42 years

DAVID L. ALLRED
Vice President
Tax
Age 57/With company
25 years

TERRY L. CARTER
Controller
Age 54/With company
28 years

MICHAEL D. DANIS
Vice President
Sales and Marketing
Consumer Products
Age 35/With company
8 years

RALPH M. DAVISSON
Vice President and
General Counsel
Age 62/With company
23 years

ROBERT P. DEVLEMING
Vice President
Expansion
Consumer Products
Age 50/With company
25 years

BARBARA M. FAILING
Vice President
Human Resources
Age 59/With company
29 years

RICHARD K. KELLY
Vice President
Wood Products Division
Age 55/With company
27 years

MICHAEL L. LAPPA
Vice President
Sales and Marketing
Pulp and Paperboard
Age 53/With company
2 years

CRAIG H. NELSON
Vice President
Consumer Products Division
Age 46/With company
23 years

DAVID J. OHMS
Vice President
Management Information Systems
Age 51/With company
24 years

JOHN R. OLSON
Vice President
Resource Management Division
Age 54/With company
24 years

MALCOLM A. RYERSE
Corporate Secretary
Age 37/With company
12 years

HARRY D. SEAMANS
Vice President
Pulp and Paperboard Division
Age 49/With company
25 years

DOUGLAS D. SPEDDEN
Assistant Treasurer
Age 43/With company
19 years

HUBERT D. TRAVAILLE
Vice President
Public Affairs
Age 63/With company
26 years

MICHAEL S. URSO
Vice President
Marketing
Wood Products
Age 45/With company
1 year

GERALD L. ZUEHLKE
Vice President
Finance, Chief Financial
Officer and Treasurer
Age 54/With company
31 years

*Ages and years of service with the company calculated as of March 1, 2003.

CORPORATE INFORMATION

EXECUTIVE OFFICES
601 W. Riverside Avenue
Suite 1100
Spokane, Washington 99201
Telephone: (509) 835-1500

TRANSFER AGENT AND REGISTRAR
Computershare Investor
Services, LLC

STOCK LISTING
Potlatch common stock is traded under the symbol PCH on the New York, Chicago and Pacific stock exchanges.

DIVIDEND REINVESTMENT
For the convenience of stockholders, dividends may be reinvested in Potlatch common stock. For information, contact Computershare Investor Services at (312) 360-5390.

ANNUAL MEETING
The annual meeting of stockholders will be held on May 12, 2003, at 8:00 a.m. at the Hotel Lusso, North One Post Street, Spokane, Washington.

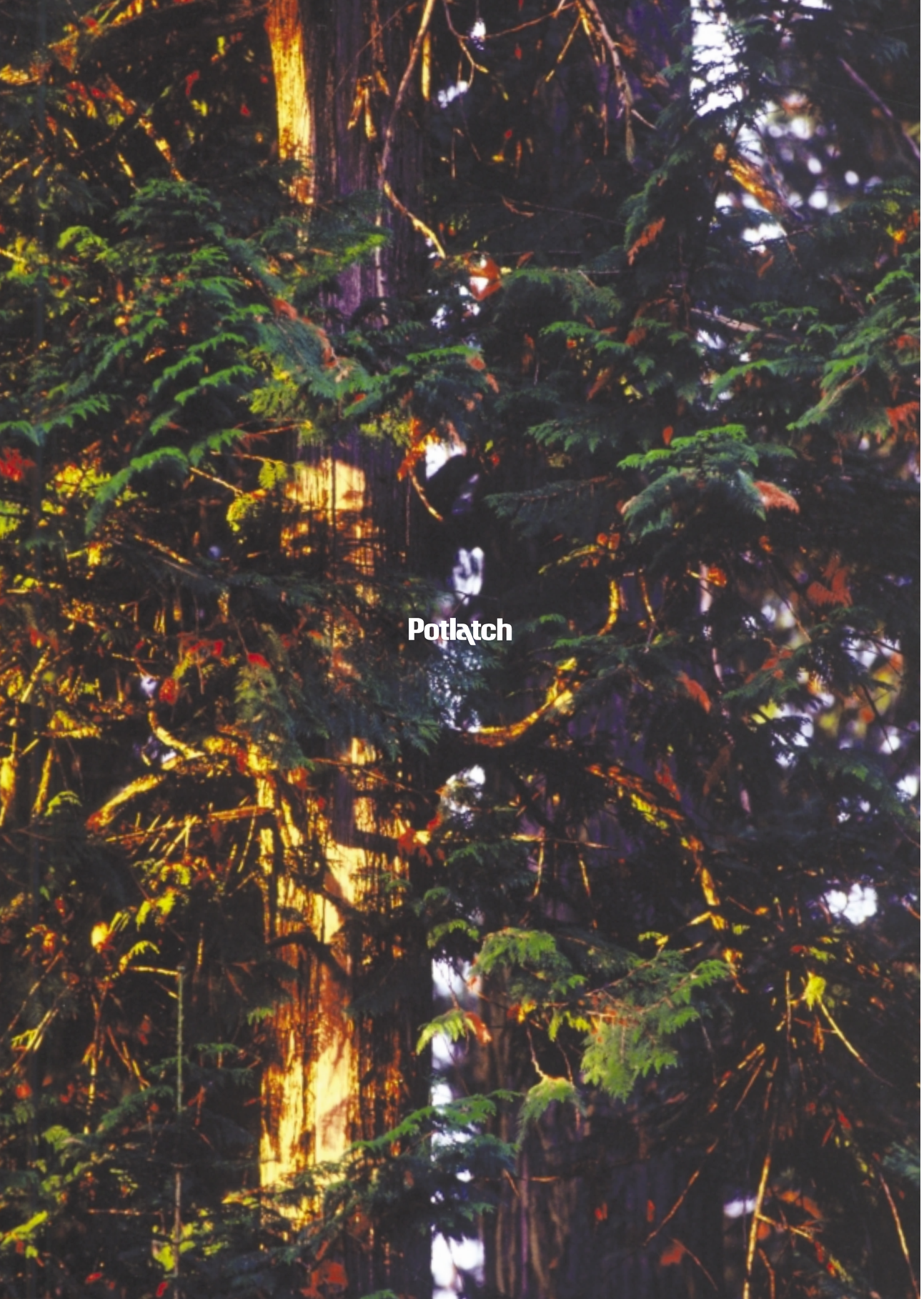
ADDITIONAL INFORMATION
A copy of the company's annual report on Form 10-K, as filed with the Securities and Exchange Commission, is available free of charge online at www.potlatchcorp.com or upon written request to Malcolm A. Ryerse, Corporate Secretary, at the Potlatch executive offices.

WORLD WIDE WEB
www.potlatchcorp.com

FORWARD-LOOKING STATEMENTS

This annual report contains, in addition to historical information, certain forward-looking statements, including without limitation, statements regarding future revenues, costs, manufacturing output, capital expenditures and timber supply issues. These forward-looking statements reflect management's current views regarding future events based on estimates and assumptions, and are therefore subject to known and unknown risks and uncertainties and are not guarantees of future performance. The company's actual results of operations could differ materially from those expressed or implied by forward-looking statements contained in this report. Factors that could cause or contribute to such differences include, but are not limited to, changes in the United States and international economies; changes in exchange rates between the U.S. dollar and other currencies; changes in the level of construction activity; changes in worldwide demand for our products; changes in worldwide production and production capacity in the forest products industry; competitive pricing pressures for the company's products; unanticipated manufacturing disruptions; changes in general and industry-specific environmental laws and regulations; unforeseen environmental liabilities or expenditures; weather conditions; and changes in raw material, energy and other costs. Forward-looking statements contained in this annual report present management's views only as of the date of this report. Except as required under applicable law, we do not intend to issue updates concerning any future revisions of management's views to reflect events or circumstances occurring after the date of this report.

Project Manager: Delphine Hirasuna Design: Pentagram Photography: Tom Tracy Printed in the U.S.A.


Potlatch